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Abstract

This dissertation highlights and analyses the results of a Survey to assess the problems of corporate governance facing Islamic Financial Institutions (IFI's) at this moment in time. The significance of the dissertation is in describing governance in Islamic financial institutions and how there are numerous matters under the investigation process, and to view the entire area of corporate governance from a religious context. A solution to deal with these problems from a religious angle, whereby the obligation of adhering to good corporate governance practices is perceived from the perspective of religious obligations. One of the objectives of this paper is to examine, and create greater awareness of, some of the critical issues related to corporate governance in Islamic financial institutions. A second, perhaps, a more significant objective is to emphasize how improvements in corporate governance in such institutions can come about by viewing them as a religious obligation, and thereby preserving their acceptance but safeguarding the interests of all stakeholders. Islamic Shariah provides guidelines that can help the Islamic finance industry alleviate problems resulting from the dualism of improving financial efficiency and observing the rules of Shariah. A greater commitment to the objectives of Shariah may allow the industry to escape the argument that Islamic finance is dissimilar in form but effectively the same in substance to conventional finance.

Keywords: Corporate governance, Islamic Finance, Islamic Financial Institutions, Shariah Governance, Ethics

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List of Key Terms

PBUH	Peace and Prayers of Allah be upon him
SWT	Subhanahu WaTala
IFI	Islamic Financial Institution(s)
CFI	Conventional Financial Institution(s)
AAOIFI	Accounting & Auditing Organization for Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IMF	International Monetary Fond
GCC	Gulf Cooperation Council
OECD	Organization for Economic Co-operation and Development
IAH	Investment Account Holder
UIA	Unrestricted Investment Accounts
BCBS	Basel Committee on Banking Supervision
OECD	Organisation for Economic co-operation and development
SSB	Shariah Supervisory Board

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Chapter 1 Introduction / Overview and Research Background

1.1 Background

Corporate governance is the system by which business corporations are directed and controlled with the structure signifying the sharing of rights and duties among the unique members in the corporation. [OECD April 1999]

There has been an increased interest in corporate governance as a consequence of events such as the Exxon Valdez disaster, or the Ford Pinto scandal sparking debates about the roles of large corporations in society and raising questions about their ethical standards, management decisions and corporate governance practices (Kiel and Nicholson, 2003).

The development of corporate governance systems conventionally has been in response to corporate failures or systemic catastrophes. One of the original failures of governance was the South Sea Bubble of the 1700s, which revolutionized business laws and practices in England. The securities law in the U.S. was commissioned due to the stock market crash of 1929, and the secondary banking crisis of the 1970's in the United Kingdom and the United States of America; the savings and loans debacle of the 1980's are examples of the responsive nature of corporate governance.

The history of corporate governance has been scattered by an arrangement of well-known company disasters, for instance, the collapse of the Bank of Credit and Commerce International, Barings Bank, Enron, WorldCom, HIH, OneTel and Parmalat, with each of these cataclysms being a result of incompetence, fraud and abuse as much as from an absence of oversight rules.

Since Enron's failure in December 2001, the corporate community and the authorities internationally have commenced examining the way corporations are run from many perspectives, including:

- Board composition and effectiveness
- Executive compensation
- Role of the investment banking community
- Stock exchange listing requirements
- Role of the accounting and auditors professions
- Voting patterns of institutional investors

Ihlas Finance House (IFH) of Turkey, the largest of the Turkish IIFS, with over 40% of the sector deposits collapsed in 2001 after it illegally misappropriated almost \$1billion, with concentrated ownership and control allowing an incentive system biased in favour of shareholders. (Starr and Yilmaz (2004). The failure of IFH revealed the risks to the financial stability and reputation of other institutions offering Islamic financial services (IIFS) because of poor corporate governance, and their inability to manage liquidity in the absence of Shariah compliant secondary markets.

The commitment of concerned stakeholders to Islamic religious principles cannot be taken for granted, and indeed the Islamic Financial Institutions are no less disposed to suffering violations of fiduciary responsibilities. The history of Islamic finance shows that cases of corporate governance failures have features in common with conventional banking scandals, including amongst others, collusion of the board with management, external and internal audit failures, neglect of minority shareholders' interests, imprudent lending, and excessive risk taking by management.

Good corporate governance is crucial to the ability of a business to protect the interests of the stakeholders, and in the case of Islamic institutions efficiency, stakeholders expect operations to be carried out in compliance with the principles of the Shariah. A corporate structure that enables an institution to implement good governance through Shariah-compliant operations is therefore fundamental.

Good Islamic corporate governance principles include honesty, trust, integrity, openness, performance orientation, responsibility and accountability to Allah and

the people, mutual respect, and commitment to the corporation and all in harmony with the Islamic Shariah.

Commonly accepted principles of Islamic corporate governance include:

- Rights and equitable treatment of shareholders as per the Shariah
- Interests of other stakeholders, as dictated by law and according to the Shariah
- Role and responsibilities (of the board) to Allah and the people
- Integrity and ethical behaviour, in compliance with the Shariah
- Disclosure and transparency

Commonly accepted principles of conventional corporate governance include:

1. Promoting transparent and efficient markets steady with the rule of law
2. Protecting shareholders' rights
3. Guaranteeing the equitable treatment of all shareholders
4. Recognising the rights of stakeholders recognised by law
5. Timely and accurate disclosure
6. The effective monitoring of the management by the board
7. The board's accountability

[OECD, 1999]

It is clear that there is an overlap between these principles, as both Islamic corporate governance and conventional corporate governance are concerned with:

1. shareholder and stakeholder rights
2. effective disclosure
3. transparency
4. accountability of management and the board
5. obeying the rule of law

Enhancing stakeholders' value is a central purpose for any business, including financial services, whether conventional or Islamic. The stability, financial performances, and ability to intermediate resources will depend on stakeholders' confidence in individual institutions and the industry. A particular confidence feature in respect of Islamic financial services is the requirement of conveying to stakeholders that their financial business is conducted in conformity with their religious beliefs. Corporate governance arrangements include structures and procedures that should provide sufficient comfort that the business is conducted in accordance with specified objectives and in meticulous compliance with Shariah.

The need for Islamic Financial Institutions to get their house in order and implement good corporate governance practices, that are in line with recognized and expected business practice as well as being compatible with the Shariah are imperative. The key word being 'implement' practices and not just pay lip service to the principle.

1.2 Statement of the Problem

Over the past decade, the world has seen a significant change in the role of the private sector in economic progress and job creation. As more and more countries have assumed market-based approaches to economic policy, mindfulness of the status of private corporations for the welfare of individuals has improved. Corporations create jobs, generate tax income, produce a wide selection of goods and services at sensible prices, and progressively manage our savings and secure our retirement income. Amid growing reliance world wide on the private sector, the issue of corporate governance has likewise increased in importance (OECD Principles of Corporate governance, 2004).

Islamic finance from the position of corporate governance represents an array of fascinating features, as equity participation, risk and profit-and-loss sharing measures form the basis of Islamic financing. The ban on interest means that an Islamic bank cannot charge any fixed return in advance, they, however partake in the profit from the usage of the funds. The depositors also share in the profits according to a pre-set ratio, and are remunerated with profit earnings for assuming the risk.

An Islamic bank is a partner with the banks depositors and the entrepreneurs and these financial arrangements infer rather diverse stakeholder relations, and therefore governance structures, as depositors have a direct financial stake in the bank's investment and equity participations. This leads to rather diverse governance issues that Islamic banks and financial institutions face as compared to conventional institutions. The Islamic financial institution is subject to an added tier of governance, compliant with Islamic law.

The most common approach at present is to establish independent Shariah Supervisory Boards (SSB's), in-house religious advisers and Shariah review units. The role of the Shariah Supervisory Board includes:

- (i) Certifying permitted financial instruments through fatawa
- (ii) Verifying that transactions comply with issued fatawa

- (iii) Calculating and paying Zakat
- (iv) Disposing of non-Shariah compliant earnings
- (v) Advising on the distribution of income or expenses among shareholders and Investment Account Holders (IAH)

A Shariah Supervisory Board's responsibilities will differ according to provisions specified in the articles of association of the financial institution or those specified by national regulators. In addition to internal corporate arrangements, national regulators and international standard setters implement guidelines for Shariah Supervisory Board's. These guidelines frequently refer to Shariah Supervisory Board's general responsibility to guarantee Shariah compliance and also at times indicate areas of competence, composition and decision-making.

The functioning of Shariah Supervisory Board's raises five main issues of corporate governance:

(i) Independence

The Shariah Supervisory Board member's dual relationship with the institution as providers of remunerated services and as assessors of the nature of operations could be seen as creating a possible conflict of interest.

(ii) Confidentiality

Some Shariah scholars sit on the Shariah Supervisory Boards of more than one financial institution, this provides the particular individual access to proprietary information of other possibly competing institutions.

(iii) Competence

Shariah Supervisory Board (SSB) members should ideally be knowledgeable in both Islamic law and commercial and accounting practices. In reality, it would appear that very few scholars are well versed in both disciplines.

(iv) Consistency

The activities of Shariah Supervisory Boards (SSB's) are in the nature of creating jurisprudence by the interpretation of legal sources. It should therefore not be surprising to find conflicting opinions on the admissibility of specific financial instruments or transactions.

(v) Disclosure / Transparency

A transparent financial institution would ideally disclose the duties, decision-making process, areas of competence, and the composition of the Shariah Supervisory Board, as well as publish all fatawa issued by the Shariah Supervisory Board.

The problem is that corporate governance is inadequate in Islamic Financial Institutions, and the author believes that this is due to the entire approach regarding the subject. Many Corporate governance structures have been put forward, implemented, along with principles and codes of behaviour. The importance of corporate governance in enhancing stakeholder value, as well as positive effects towards the organisation have been spoken and written about by many researchers and scholars.

However, there is still something missing, there is a piece of the puzzle that is still not in place. The author believes that it is the fundamental view of corporate governance and the importance of it that is missing. The author will attempt to prove that corporate governance is a duty on every Muslim, as is prayer, hajj and other such duties incumbent on every Muslim. Therefore, the application of it is not a matter of choice, and nor should it be looked at from the benefits of doing so, although these are important, but rather should be considered at from the angle of being an obligation. Therefore, the application of corporate governance procedures is a form of worship, and also a duty for which a Muslim will be held accountable. He / she will be rewarded for their application and held accountable for neglecting them or inadequate application.

It is not enough to assume that just because someone is a Muslim, and by that very nature is expected to obey the Shariah, that he / she will ensure that they do not do anything that will be against the Shariah in terms of corporate governance

duties. Although, in theory there is a mechanism of self-accountability, honesty, trust and therefore should be self-regulatory, the fact of the matter is that, this is just not the case, and a vigilant eye is necessary.

One day Prophet Muhammad (peace be upon him) noticed a Bedouin leaving his camel without tying it and he asked the Bedouin,

"Why don't you tie down your camel?"

The Bedouin replied:

"I put my trust in Allah."

The Prophet then said:

"Tie your camel first, then put your trust in Allah"

[At-Tirmidhi Hadith No: 2517]

This refers to the common sense and reasoning that Allah in His Infinite Mercy has bestowed upon the human intellect, so that we are able to take due precautions, plan and prepare for possible future events, and create a means of addressing those needs on our own. Therefore, preventative and preparative actions are necessary in all walks of life, and especially business. The need for regulation to ensure accountability is necessary, and not just relying on self-regulation due to the people following the Shariah of their own accord.

1.3 Research Aims and Objectives

Research studies in the field of corporate governance are wide-ranging, with a great deal having been written about the benefits of good corporate governance, as well as on governance structures needed to ensure good corporate governance.

Connected to the inconsistency of the theory and practice of Islamic Corporate governance, many precise research questions can be posed.

- What does the Islamic system of life mean for corporate governance of financial institutions?
- How do Islamic principles apply to corporate governance?
- What regulations and guidelines does the Shariah provide to regulate corporations?
- How does the Islamic Corporate governance approach compare with the conventional approach to corporate governance?
- Is there a convergence in the approaches to corporate governance (Islamic and conventional) or is there divergence?
- If approaches are 'divergent', how can the divergences be utilized in order to govern corporations on an Islamic basis? What standards need to be laid down if approaches are convergent?

The problems facing Islamic Financial Institutions in terms of corporate governance are fundamentally no different than those facing conventional banks and financial institutions, except the additional need for conformity to the Shariah which give rise to further potential issues.

How does an Islamic financial institutions meet these challenges it is facing with regards to corporate governance? It is easy to talk about the need for good corporate governance and the benefits of it, but how does an Islamic financial institution meet the requirements?

The Islamic financial institution must understand the role of the Shariah and the implications for an organisation and subsequently corporate governance.

The problems can be summed up as follows:

- Islamic Financial Institutions need to comprehend the objectives, role and purpose of the Shariah
- Islamic Financial Institutions need to appreciate the importance of good corporate governance
- Identify the problems that the organisation is facing with regards to corporate governance issues that are specifically related to the Shariah

Primary Research objectives of this research:

- To identify the specific corporate governance issues / problems facing IFI's. Does an Islamic way of life provide a solution to these corporate governance issues / problems?
- To identify specific Shariah related corporate governance issues / problems. How do Islamic principles, if at all, apply to corporate governance? Why is it that these problems exist for IFI's is there are Islamic principles that do provide a solution?
- To identify potential solutions for these issues / problems from an Islamic angle. Are there guidelines setup that provide solutions from Shariah principles? Who has set them up and why do these problems still persist?

Secondary Research objectives of this research:

- Do all the IFI's face similar problems across the globe, or are these problems regional?
- Are there state / government implemented approaches to corporate governance for IFI's that eliminates these problems in certain geographical regions?
- Is it really a problem of a lack of good corporate governance principles or is it negligence in implementation of these principles by IFI's?
- Are the approaches to CG for IFI's and conventional financial institutional converging or diverging?

The author postulates that research will indicate that for both IFI's and conventional financial institutions, corporate governance approaches are converging. The divergence being in the mechanism of implementation only, due to the added layer of Shariah compliance. The basic corporate form has already achieved a great deal of uniformity, where economies are approaching a worldwide consensus that managers should act in the interests of all shareholders.

There are three principal factors driving economies towards consensus:

1. Failure of alternative models
2. Competitive pressures of global commerce
3. Shift of interest group influence in favour of an emerging shareholder class

There is evidence of convergence in a number of areas. Shleifer and Vishny (1997) and Hansmann and Kraakman (2000) report that governance systems in Germany, Japan, and the US show signs of convergence. Large shareholders are on the rise in US firms, whilst board structures in Germany and Japan are moving increasingly towards the US model of a single-tier board that is comparatively small and has both insiders and a meaningful number of outsiders.

This may be true of conventional approaches to dealing with corporate governance issues. Is it also true for Islamic corporate governance (compared to conventional approaches)?

What about convergence in corporate governance mechanisms other than the legal system?

Islam is the religion of 'Fitrah', and all human beings are born with the same innate belief and disposition, and hence will converge at some point in their approaches. A Muslim is not sent from another planet; a Muslim is just another human being who has remained on the innate disposition with which he / she was created. Therefore, an approach to management issues by those following Islam or any other religion, or no religion at all, will at some point converge, as their source is but the same.

They may follow different religions, but humans in general, regardless of gender, nationality, religion, race or colour essentially have the same concerns and worries in life. In business the same applies as in life; according to the author, therefore the need to solve the same common problems is there for all humans. They will, however, differ on ways to solve the problems, which the author believes, will also ultimately begin to converge. The world is getting smaller due to technology advances and information is so readily available and so quickly accessible for all and from the comforts of your home. Individuals can now explore, analyse and investigate their problems and find solutions for them using the information highway and the numerous experts offering their advice and guidance. The need to formulate your own solutions, in order to make money is greater, as competition is stronger. In the changing and evolving world, the leaders of business need to change and evolve also, and in fact need to do so ahead of the competition. Investors expect it, they in fact demand it and if you are not able to meet their requirements, they will go elsewhere.

The author believes, all this leads to a convergence in corporate governance, as best practice is shared or even imitated by others, there is a need to ensure that

the best corporate governance structures are implemented within your organisation to gain business confidence. If this means to copy or use someone else's, then that will have to be done. This will eventually lead to a convergence in how they are implemented also, but presently corporate governance structures will converge, but with the addition of meeting the needs of the Shariah for institutions offering Islamic financial services (IIFS).

The Islamic approach and has never been and is in no way opposed to conventional management approaches. As it is the way of life which our inner selves naturally converge towards, therefore approaches which try to achieve the same goals should converge somewhere along the route.

"Corporate governance is about promoting corporate fairness, transparency and accountability"

[Wolfensohn, 1999]

The definitions of corporate governance as diverse as they maybe, are very similar in both Islamic corporate governance and conventional corporate governance approaches. As the goals of corporate governance are similar, then it is just natural that there is convergence in the approaches. Although the mechanisms in the implementation of them should differ, as one approach follows the law of the land and national regulations, whilst the other approach follows the Shariah additionally to the law of the land and national regulations.

1.4 Significance of the research

The aim of this research is to fill a gap that the author feels has not been filled adequately. There is a great deal of literature on what constitutes Islamic corporate governance, and the importance of corporate governance. Many researchers and authors have covered the need for corporate governance, the importance of it, principles and governance structures.

The author, however, feels that there is not a 'religious' approach to corporate governance. Although we are talking about Islamic financial institutions, which base their approach to finance on the Shariah, it is believed that the approach to corporate governance should also be more grounded in Shariah principles.

The author will approach this subject from an 'Islamic' perspective, by first highlighting the duties incumbent on a Muslim in his / her everyday life due to being a Muslim, and establishing clearly from the Qur'an and the Sunnah that business dealings are as important in a Muslims life as prayer. A Muslim is duty bound to follow the rules of the Shariah, they are not discretionary nor are they at the whims of the Muslim. A part of the duty on a Muslim is his / her obligations at work, in business and when holding responsibility over others; corporate governance is one of these areas.

This research will establish the importance of these duties, and apply them to a business and the businesses corporate governance issues. The solutions to the problems of corporate governance in Islamic Financial Institutions will be from classical sources of Islam, taking into account the opinions of the different Madhabs. The uniqueness and significance will be in how these problems are viewed and the solutions being provided from classical sources.

1.5 Scope / Limitations of the Study

The Survey results will provide a good idea of some of the major issues faced by Islamic Financial Institutions with regards to corporate governance. Restraint is advised in drawing inferences due to the small size of the sample under study.

Although the author would like to explore a vast array of Islamic Financial Institutions in Islamic and non-Islamic countries, as well as those that are fully Shariah compliant along with those with Islamic windows. It may not be possible, for several reasons, for this to happen, which will of course limit the empirical scope of the study.

Another possible limitation could be the Shariah guidelines being provided. The author intends to use the opinions of 'classical' scholars of Islam to provide the solutions; due to the following of the different Madhabs by those in positions of authority in Islamic Financial Institutions, this may lead to problems of acceptance. Where possible, different views will be accommodated and opinions provided.

If time permits, the author will research the views of the scholars of the various Madhabs on these problems and their subsequent solutions. This would in turn provide more detailed, and thorough and wide-ranging opinions on the solutions to the problems facing Islamic Financial Institutions. A view from each of the Madhabs based on their classical scholars would provide wide-ranging opinions and points of analysis.

Many of the respondents (305 of them) could have been from the same company, so they could be providing the same information and hence the same viewpoint again and again, this would distort the statistics, as although it seems like 305 respondents, the number of companies represented in the survey could be quite small. The fact that they maybe from the same company can also distort the results, as a greater portion of one particular company may lead to an unbalanced interpretation of the results.

It is feasible also that the respondents did not have accurate information regarding

some of the questions in the survey, and so gave an opinion based on his / her interpretations. This again would lead to unbalanced responses and distort the statistical analysis.

The researcher has not analysed the Internet IP addresses of the respondents in order to determine the locations of the respondents for a number of reasons. They included confidentiality, if the respondent did not wish to identify their location or company where he / she worked, then IP analysis would betray this trust. Also, some respondents may be responding from other than their place of work or country of location, so an analysis of IP addresses would be misleading.

Chapter 2 Literature Review

Corporate governance is about how a business should fulfill the obligations it owes to shareholders and all other business stakeholders, and is established on the three principles of transparency, accountability and adequate disclosure. Corporate governance has become significant with the increased cognizance of the significance of safeguarding the rights of all stakeholders.

The observation was articulated with the publication of the Cadbury Report in 1992. Subsequent reports continued to develop on the Cadbury report, eventually taking form as the OECD Principles of Corporate governance in 2004, being instantly adopted by the EU, World Bank, USA and other OECD and non-OECD countries (Morck, 2005).

The expression corporate governance refers to the way in which an organization is directed, administered, or controlled and embraces the set of policies and practices that affect manager's decision making and contributes to the way a company is seen by current and potential stakeholders. Good corporate governance procedures substantiate that the management team is held suitably responsible and boosts personal integrity, strong internal controls, and suitable risk management practices at the institution and obliges a discipline on managers to maximize returns to the firm.

Significant efforts have been under way since the early 1990's within the OECD, the European Commission and individual European countries to appreciate the economic consequences of corporate governance and to frame recommendations on suitable governance structures and practices (Weil, Gotshal & Manges, 2002).

Scholars and practitioners of corporate governance give the term an assortment of definitions; economists and social scientists tend to define it broadly as,

"the institutions that influence how business corporations allocate resources and returns"

(Mary O'Sullivan, 2000)

and

"the organizations and rules that affect expectations about the exercise of control of resources in firms."

(World Bank, 2002).

The economic view of corporate governance says that managers of the company are the guardians of the assets and their main duty is to use those assets competently in the pursuit of the firm's objectives and generate value for the shareholders.

Mathiesen (2002) says,

"corporate governance is a field in economics that investigates how to secure / motivate efficient management of corporations by the use of incentive mechanisms, organisational designs and legislation. This is often limited to the question of improving financial performance, for example, how the corporate owners can secure/motivate that the corporate managers will deliver a competitive rate of return".

According to Guillen (2000), corporate governance plays a key role in any economy by providing a structure for the division of labour and financial results in the firm. He restates the fact that a well functioning corporate governance system can contribute to economic efficiency and even social equity.

"Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment",

[Shleifer & Vishny 1997]

The Cadbury Report (1992) defines corporate governance as,

"Corporate governance is the system by which businesses are directed and

controlled”.

This definition focuses almost entirely on the internal structure and operation of the corporation’s decision-making processes.

The legal viewpoint of corporate governance specifies the procedures and rules that postulate the incentive framework for companies to seduce financial and human capital, perform competently and avoid corruption (World Bank, 1999).

The societal viewpoint is about communications, how the company presents itself to groups with a valid interest in the company’s dealings. This view rests on the principle that, whilst corporate governance is primarily concerned about the relationship between shareholders, management and the board in determining the direction and performance of the corporation (Monks and Minow, 2001), the scope ought to be even broader, incorporating ethical standards and crisis management.

"Corporate governance is about promoting corporate fairness, transparency and accountability"

[Wolfensohn, 1999]

Most definitions refer to two things:

1. Mechanisms by which corporations are directed and controlled
2. Mechanisms by which those who direct and control a corporation are overseen

This core view implies that it relates to how the many communities that define the business enterprise serve, and are served by the firm.

According to Nordin (2002) corporate governance has two components:

1. Self-governance relating to areas that are problematic to legislate
2. Statutory regulation of governing authorities

Corporate governance in Islamic Financial Institutions symbolises a number of thought-provoking features due to equity participation, risk and profit-and-loss sharing measures, these in turn assume different stockholder relationships, and governance structures. Iqbal and Mervyn (2000), seek to outline an Islamic variant that includes more of an ethical dimension than simple stakeholder theory.

Hassan (2009) advocates that corporate governance is indisputably one of the vital essentials of any corporations' development and an even greater test for the firm due to the additional risk compared to the conventional banking system.

The surveys of Siddiqi, (1981) and Haneef, (1995), on the contemporary literatures on Islamic economic thought establish that there is an absence of references and dialogue on the theme of corporate governance from the Islamic standpoint. Mannan, (1984) in his assortment of abstract of researches in Islamic economics also further stresses the lack of explicit research on Shariah governance.

Banaga (1994) undertook a research study of external auditing and corporate governance in Islamic banks. Chapra and Ahmed (2002) wrote a book on Islamic corporate governance precisely concentrating on the issue of governance framework of Islamic financial institutions (IFI), both studies focused on the issue of auditing, accounting, general framework of corporate governance of Islamic banks.

The definition of corporate governance from an Islamic viewpoint does not contrast much with the conventional definition, as both definitions refer to a system by which companies are directed and controlled with a purpose to meet the corporation's objective by safeguarding the stakeholders' interests and rights. Distinctively corporate governance within the Islamic model gives unique characteristics and features in contrast with the conventional system owing to the unique case of broader decision-making theory that uses the idea of Islamic socio-scientific epistemology that is premised on the divine oneness of Allah (Choudury and Hoque, 2004).

Corporate governance plays a fundamental role in the design and promotion of the principles of accountability, fairness and transparency of the companies to

safeguard investors' interests. IFIs have been criticized for the lack of accountability and transparency, after some major scandals in relation to several respected IFIs. The Dubai Islamic Bank in 2009 where a lack of corporate governance practices resulted in a fraud case involving \$501 million attracted the attention of economists, scholars and institutions to research and work on the improvement of corporate governance practices in IFIs.

Khan and Sharif (2008) contend that,

“The level of good governance required by sharia principles arguably transcends that of conventional financial systems, as Islamic financial principles categorize an IFI as a trustee of its investors. As such, the IFI must be transparent, act fairly and be held accountable to the investors. Considering the significant amount of wealth currently entrusted to IFIs and their role as the trustees of their investors, is it time for the introduction of more robust corporate governance practices tailored specifically for IFIs?”

According to Khan and Sharif (2008), whilst conventional systems of corporate governance practices are converging, governance practices of IFIs seem to be diverging. This may be due to regulators responsible for supervising IFIs taking a non-prescriptive tactic, whereby rather than setting criteria and standards which IFIs must comply with to be authorized and licensed, the responsibility is placed on the individual IFIs to put suitable measures in place to ensure that the services and products they offer meet with Shariah principles.

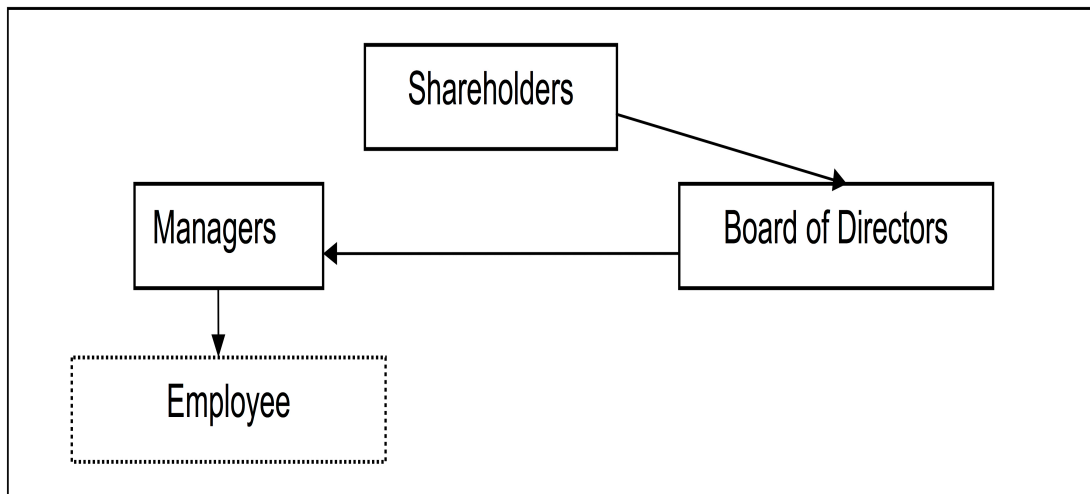
Choudhury and Hoque (2004) consider that the objective meanings of corporate governance in Islam is to state and achieve an objective measure by means of understanding the relations between critical variables supported by policies, programs and strategic partnership. Corporate governance in Islam plays vital roles in order to meet the goals and objectives of the corporation with Islam adding additional value through Maqasid Shariah.

The core objective of corporations is to increase the shareholder's value of wealth; this implies that in practice, numerous Islamic corporations assume the Anglo-

Saxon model of corporate governance (Lim, 2007).

The Anglo-Saxon model, also known as market-based systems or shareholder value system or principle-agent model is considered as the leading theory supported by the United States and the United Kingdom. The systems are characterized by an arm's length relationship between corporations and investors who are said to be troubled mainly about short term returns (Frank and Mayer, 2004).

Figure 1: The Anglo-Saxon Model of Corporate Governance



Source: Cernat, (2004: 153).

The above figure shows that the Anglo-Saxon model built on the corporate concept of fiduciary relationship between the shareholders and the managers motivated by profit oriented behaviour. A distinctive facet of the Anglo-Saxon system is the structure of corporate ownership where the share ownership is extensively spread and shareholders impact on management is frail. The central obsession of corporate governance in the Anglo-Saxon system is to guard the interest and rights of the shareholders.

Studies on corporate governance for Islamic Financial Institutions imply that Islamic corporation may adopt a completely unique model of corporate governance or an adapted form of the Stakeholder oriented model as an alternative for its

framework. The former refers to the model built on the principle of consultation where all stakeholders share the same goal, the oneness of Allah (Choudury and Hoque, 2004) and the latter concerns on adopting the stakeholders' value system with some adjustments (Iqbal, and Mirakhor, 2004) and (Chapra and Ahmed, 2002).

Any Islamic corporation specifically Islamic financial institution needs to have a suitable governance framework to guarantee the company's growth and success.

Corporate Governance and the agency problem

"The trade of a joint stock company is always managed by a court of directors. This court, indeed, is frequently subject, in many respects, to the control of a general court of proprietors.

...The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own...."

[Adam Smith, 1776]

Whatever the tangible discipline of corporate governance a considerable capacity for managerial discretion remains leading to an agency problem, as well as a problem of mutual action.

Agency theory relates to relationships in which the principal delegates the duty of running the firm to the agent, where the agent "acts for" the principal. Two problems arise in agency relationships.

1. The agent and the principal might have conflicting goals
2. The principal and the agent have different propensities to accept risk

Agency theorists deem a structure of corporate governance as efficient if it assures that suppliers of finance obtain an appropriate return on their investment (Shleifer and Vishny, 1997).

Agency theory is concerned with bringing into line the interests of owners and managers (Jensen and Meckling, 1976; Stano, 1976; Fama, 1980; Fama and Jensen, 1983) and is founded on the idea that there is an intrinsic struggle concerning the interests of a firm's owners and the firm's management (Fama and Jensen, 1983).

The consequence of agency theory on corporate governance research can be seen in the supremacy of studies that examine two key questions:

1. How the composition of boards of directors affects firm performance (e.g. Barnhart and Rosenstein, 1998; Wagner et al., 1998)
2. How the leadership structure of the company, the duality of the CEO/ chairman role affects corporate performance (Dalton et al., 1998)

As to the instrument by which a board is likely to impact on corporate performance, agency theory suggests that a greater proportion of outside / independent directors will be able to monitor any self-interested actions by managers. As a result of the checking, there will be a lower chance for managers to pursue self-interest at the cost of owners and so shareholders will receive greater returns.

The agency model is widely recognized in the corporate community, as can be seen by the general acceptance of normative guidelines emphasizing the need for independent directors to monitor the behaviours of the board (Bosch, 1995; NACD, 1996). Agency theory holds that managers will not act to maximise the returns to shareholders unless suitable governance structures are applied to the large corporation to safeguard the interests of shareholders (Jensen and Meckling 1976). Agency theory declares that in the modern corporation where share ownership is widely held, managerial actions depart from those needed to maximise shareholder returns (Berle and Means 1932; Pratt and Zeckhauser 1985).

How relevant is Agency Theory in the corporate governance model of Islamic Financial Institutions?

In Islamic finance corporate governance, the agency problem is of primary concern. The theoretical structure of IFIs, which share profits and losses on both their asset and liability sides, pose a greater need for transparency to its investment account holders (Iqbal et al. 2007, p. 7).

Iqbal et al further explain it as follows,

“This is due to the agency problem faced by the investment account holders when they share in profit and loss of the bank, which themselves are the consequence of trade and investment decisions of the managers and shareholders of the banking firm. Bank shareholders (or their appointed management), as agent for investment account holders, exercise control over investment decisions. Unless their interests and risk profile is aligned with that of the depositors, agency problem will remain.”

[Iqbal et al, 2007]

A number of agency problems are faced in the contractual structure of Islamic banks that may affect the corporate social responsibility (CSR) disclosure presented by Islamic banks in their annual reports (Iqbal et al. 2007, p. 226). Safieddine (2009), by conducting one of few important empirical researches in this field, highlighted the specific agency problems that current corporate governance practices by IFIs face in the Gulf Cooperation Council member countries. He highlighted the following deficiencies in corporate governance practices of IFIs that could possibly lead to agency problems:

- Formation of a governance committee is uncommon among IFI's
- Formation of an audit committee is uncommon among IFI's
- Clear internal audit functions are not properly established
- Lack of access to relevant information and influence on management decisions from Investment accounts holders and other investors

While investment accounts holders trust managers with their money and solely accept the risk of the projects failure, they are not able to keep a track on the performance of their investments or oversee the activities undertaken by the management, leading to some agency problems remaining unresolved (Safieddine 2009).

Chapra and Ahmed (2002) surmise that the governance mechanisms that aim at protecting the interests of shareholders in conventional corporate structures may be insufficient for IFIs.

Safieddine (2009) concludes that,

“The implications reveal that a model of conventional and idiosyncratic governance practices that preserves both the foundations of Islamic finance and the rights of all investors, including investment account holders is much needed to be developed by regulators and adopted by Islamic banks given the implications on performance and the development of the industry.”

A further problem underlined by detractors is the conflict of interest arising from relations of top management and the Shariah boards. Shariah scholars are being appointed by shareholders also influenced by top management, some Shariah scholars may feel the pressure and threat of losing their position on the board, and thus may approve products as being Shariah compliant whilst they are not. This could lead to huge costs including litigations, loss of revenue and a decline in the IFI's reputation. This problem is more emphasised by the fact that in the majority of IFIs, the Shariah boards are not subjected to disclosure rules. In order to cope with this problem there is a need for more transparency and disclosure by the Shariah boards.

Shareholder interests will be safeguarded only where the CEO does not hold the chair of the board or where the CEO has the same interests as the shareholders within an aptly developed enticement compensation plan (Williamson 1985). With both of the positions being held by the same individual, the shareholders interest will not be of paramount importance to the CEO.

Chapra (1992) is of the view that no western secular policy will flourish in challenging the core problem of the morality of corporate governance; this is because the filter instrument within which capitalist economies operate is not only poor in confronting ethical issues, but in most cases value judgements and ethics do not have a standing in mainstream economics as well as in corporate governance literature. The filtering instrument of the market, based on decentralised decision-making, driven by prices alone is unsuitable in trying to solve the main trials facing the world, a moral filter is essential.

The pursuit of the morality of corporate governance involves a perception, which goes past pure economic efficiency and equity criteria. The key question being, to who are human beings answerable to?

How does a worldview and strategy embrace the concept of the morality of corporate governance?

According to Amartya Sen (1987),

"The distancing of economics from ethics has impoverished welfare economics and also weakened the basis of a good deal of descriptive and predictive economics".

His inference is that economics,

"Can be made more productive by paying greater and more explicit attention to ethical considerations that shaped human behaviour and judgement".

[Amartya Sen (1987)]

Consequently, it is essential to focus on human beings themselves rather than on the market. Corporate governance reform cannot be resolved by simply more criteria or increased guidelines and passing more legislation does not guarantee corporate scandals from happening, nor do governance rules and their compliance promise intellectual trust and honesty. The solution lies in the remoralisation of

human behaviour and the wider society, and the solution in fact lies in reorganising the entire society and reorganising an economic system in such a manner that, there is a transformation of the individual from the economic man to a morally aware human being who is ready to live up to the demands of brotherhood and socio-economic justice.

The cause of corporate governance failure lies not in the rules of the game, but with the behaviour and attitudes of members of society, notably those trusted to boards of directors. Conventional corporate finance experts have overlooked this facet for it would seem that the academic literature produced by these experts has become progressively irrelevant to private policymaking.

Stakeholder Model

The definitions of a stakeholder are imprecise and disputed and have changed over the years Freeman (1984) defines stakeholders as,

“Those groups who are vital to the survival and success of the corporation”.

The traditional definition of a stakeholder is,

“Any group or individual who can affect or is affected by the achievement of the organization’s objectives”

[Freeman 1984]

Freeman (2004) added the consideration of the viewpoint of the stakeholders themselves and their actions as being vital to be taken into the management of companies.

He states:

“The principle of stakeholder recourse. Stakeholders may bring an action against the directors for failure to perform the required duty of care”

[Freeman 2004]

Friedman (2006) states that this definition is more balanced and broader than the definition of the Stanford Research Institute (SRI). The expression “can affect or is affected by” appears to contain individuals from outside the firm and also groups who may consider themselves to be stakeholders of an organization, exclusive of whether the firm considers them to be as such.

Friedman (2006) states that the organization itself should be thought of as a grouping of stakeholders and the purpose of the corporation should be to manage their interests, needs and positions.

The stakeholder, also known as the insider or bank-based model, and often named the Rhineland model, is one which an assortment of firm constituencies, including employees, suppliers and customers, and the communities' companies are situated in have a say in the firm, and the interests of them all are to be balanced alongside each other in management decision-making (Aoki, 1999).

Friedman (2006) expressed disapproval of the stakeholder method, when he alleged:

“That group of writers come to coalesce around particular social constructions of reality, leading to writers referring to stakeholders without being aware of relevant theoretical issues that have been raised in other literatures.”

Roberts and Mahoney (2004) have scrutinized 125 accounting studies that used the stakeholder language and revealed that nearly 65 percent “use the term stakeholder without reference to any version of stakeholder theory”.

Managers are treated differently in the literature, with certain writers regarding them as stakeholders whilst others exemplify them in the establishment's actions and responsibilities. A very fascinating view of managers came from Aoki (1984), who viewed managers as referees between investors and employees.

Freeman (1984) and Savage (1991) gave two definitions of a stakeholder:

1. "Group of people who can affect or can be affected by the achievement of the organization's objectives" (Freeman, 1984)
2. "Those groups who are vital to the survival of the organization" (2004)

As these are diverse views on what stakeholders actually are, this leads to two opposing views (Kaler, 2002), the 'claimant' definition and the 'influencer' definition of what it is to be a stakeholder and the combinatory definition: any group or individual that "can affect or is affected by the achievement of an organisation's objectives" (Freeman, 1984). This description has emerged as the most well known of the definitions of a stakeholder, and has more accuracy than the shorter version "those who can affect or can be affected by the firm".

The literature contains many efforts at categorizing stakeholders using numerous conditions, (Frooman, 1999; Pesqueux et al., 2005; Phillips, 2003b; Winn, 2001): primary versus secondary, direct or indirect, generic versus specific, legitimate versus derivative, strategic and moral, core, strategic and environmental stakeholders, etc.

Mitchell (1997) gave a theory of stakeholder identification and salience built on the qualities of power, legitimacy and urgency, relationships between managers and stakeholders and the way to group them originated from Mitchell, Agle, and Wood (1997).

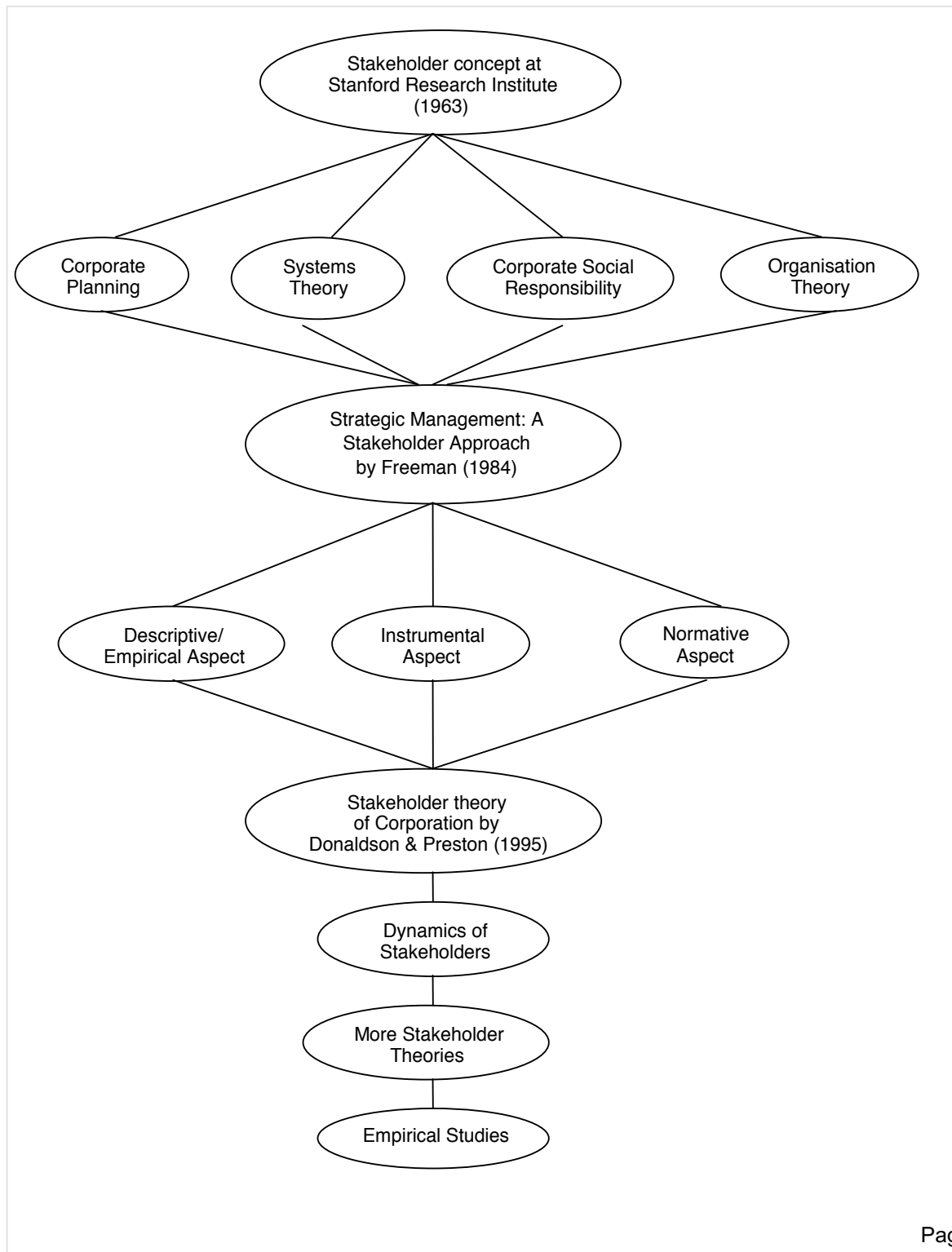
Phillips (2003b) distinguishes normative stakeholders, derivative stakeholders and dangerous or dormant stakeholders. Normative stakeholders are persons to whom the organisation has a moral obligation of fairness (Phillips, 2003b). An added persuasive basis for classification of stakeholders considers the level of the environment: the resource base, the industry arrangement and the social political arena (Post et al., 2002a).

There are three important stages in the development of this literature, namely, as

shown in Figure 2.

1. Classical stakeholder
2. Strategic management
3. Stakeholder approach

Figure 2: The development stages in stakeholder literature. [Freeman, 1984]



Researchers differ in their worldview on stakeholder notions, but most of them recognize Freeman's book as a landmark in stakeholder literature. According to Freeman (1984), productive transactions with stakeholders are constructed on accepting the validity of the stakeholder and having processes to surface their concerns.

Limited management themes have created more debate in recent decades than the basic notion, the model and the theories surrounding stakeholders (Donaldson and Preston, 1995; Friedman and Miles, 2006; Gibson, 2000; Wolfe and Putler, 2002). Stakeholder theory can be understood as "a genuine theory though a perfectible one" (Le'pineux, 2005). The pictorial authority of the stakeholder model and the simplicity of it are seen as contributing to the triumph of the stakeholder notion (Fassin, 2008).

The extraordinary research on stakeholder theory has continued along three lines:

1. The descriptive
2. The normative
3. The instrumental view

(Donaldson and Dunfee, 1994; Donaldson and Preston, 1995;
Friedman and Miles, 2006; Hendry, 2001)

Freeman added a fourth dimension,

4. Metaphorical use of 'stakeholder'"

(Freeman, 1994)

The criticisms from philosophical and theoretical positions have been widely cited upon in the scientific literature (Donaldson and Dunfee, 1994; Donaldson and Preston, 1995; Friedman & Miles, 2006; Gibson, 2000; Gond and Mercier, 2004; Kaler, 2003; Key, 1999; Moore, 1999; Sternberg, 1996; Weiss, 1995).

A summary of the literature builds the impression that the ideas surrounding the

stakeholder are mentioned to in uncertain ways (Egels, 2005; Le´pineux, 2005; Stoney and Winstanley, 2001).

There is an absence of clearness and consistency in the meaning of a stakeholder, and certainly of a stake (Waxenberger and Spence, 2003). There are certain essential inconsistencies among some definitions and the graphical representation of the model. There is insufficient rigor in using the framework to managerial, organisational and strategic matters: “much of stakeholder literature is prone to magnifying, blurring and/ or neglecting” (Wolfe and Putler, 2002).

The stakeholder theory suffers from numerous shortfalls and failings “owing in part to vagueness, ambiguity and breadth of the stakeholder theory itself” and in part to the “wide-ranging intuitive appeal, critiques are often implicit” (Phillips et al., 2003), whereas Hall and Vredenburg (2005) note that “stakeholder ambiguity is difficult to manage because it is idiosyncratic and context-specific”.

Stakeholder theory is understood as unsuccessfully tackling the environment surrounding a firm (Key, 1999). The model endures a problem of delimitation of the borders of the firm, with the diverse levels not clearly drawn. Stakeholders around the firm, particularly those in the direct business environment and those in the wider environment are slightly puzzled. Stakeholder theory is “mainly utilised to operationalise the question of to whom businesses have a responsibility” rather than for what (Egels, 2005).

How relevant is the stakeholder model of corporate governance in an Islamic economic system?

A stakeholder-oriented theory of corporate governance finds solid foundations in the Islamic economic system. The shareholder model stresses that the objective of the firm is maximization of shareholders’ wealth, and managers as agents of the shareholders have a fiduciary duty to include in activities that help achieve this. A massive literature is devoted to distinguishing appropriate contractual mechanisms in order to resolve the difficulties related with this principal-agent relationship. A fairly sizeable amount of studies have appeared that scrutinise this issue in the

perspective of Islamic financial contracts in general and participatory contracts in specific.

Iqbal and Mirkhor (2004), point out that business ethicists have typically viewed this outcome to be ethically intolerable since it unreasonably neglects the rights of non-shareholder groups. Does this suggest that we may find a suitable model of corporate governance in the field of Islamic ethics in contrast to the Islamic law of contracts?

Islamic commercial law is rather unambiguous around the rights and obligations of parties in contractual mechanisms governing the employer-employee and seller-buyer relations. Provisions seeking to guard the weaker party are fairly routine in the Islamic law of contracting. However, law does not consider all the externalities imposed by shareholder wealth maximization choices on non-shareholder stakeholders. For example, a Mudaraba contract may be ended with the agreement of mudarib and rabb al-mal after a fixed period leading to the closure of business. However, this may lead to local communities suffering profoundly from the conclusion of this business. Even while the law would allow the owner of the business to pursue closure, ethical worries may petition the businesses continuation.

Correspondingly employees invest considerable human capital in the firm, while as per the explicit Ijarah contract, an owner may terminate the employment after the contractual period is over, ethical concerns may petition his continuation for a time period long enough to find other employment.

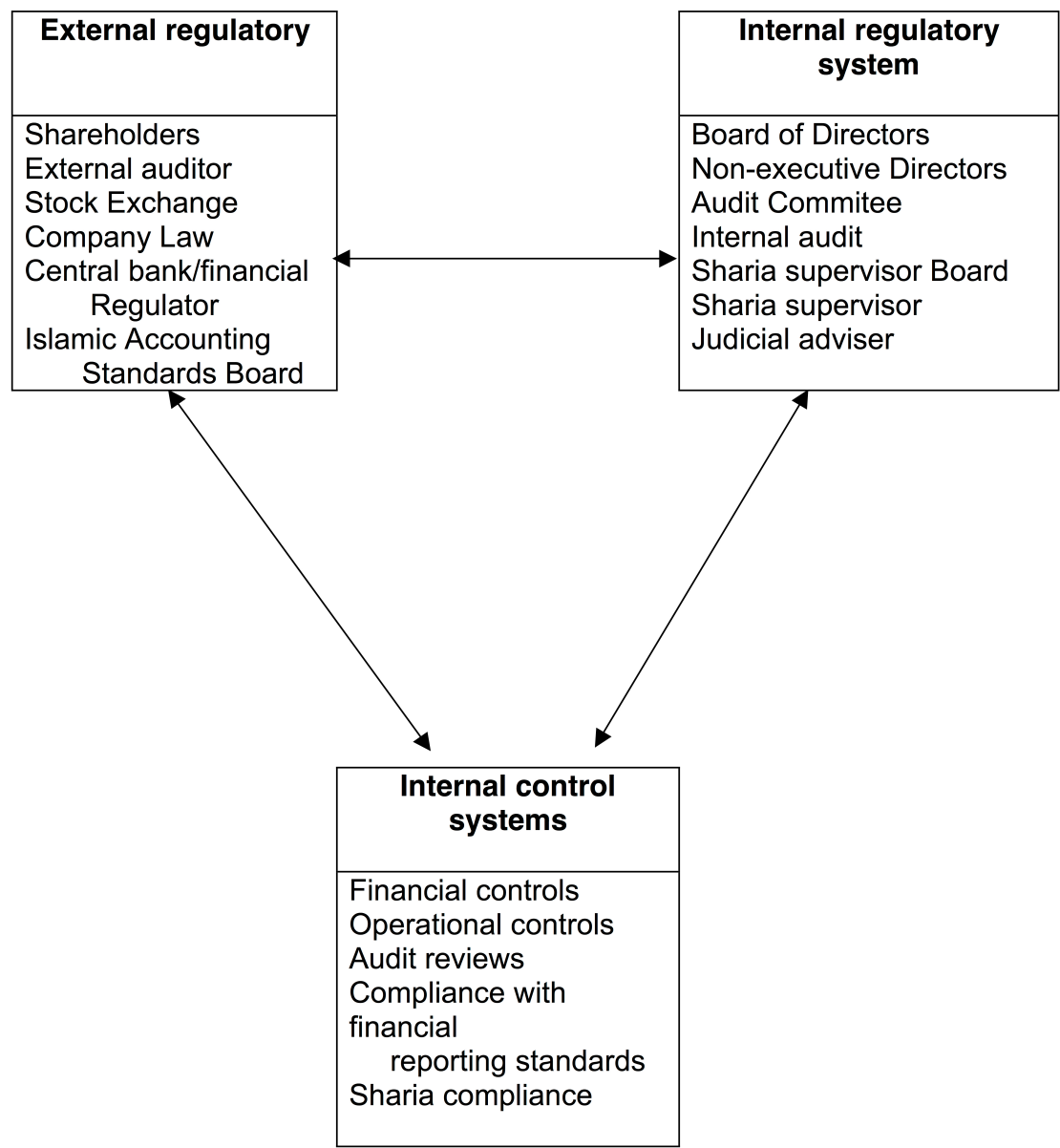
Iqbal and Mirkhor (2004), note,

“A firm in Islamic economic system can be viewed as ‘nexus-of-contracts’ whose objective is to minimize transaction cost to maximize profits and returns to investors subject to constraints that these objectives do not violate property rights of any party whether it interacts with the firm directly or indirectly.”

Islamic Governance Structures

Figure 3, which sketches a conceptual framework of corporate governance for Islamic banks, central to such a framework, is the Sharia Supervisory Board (SSB) and the internal controls.

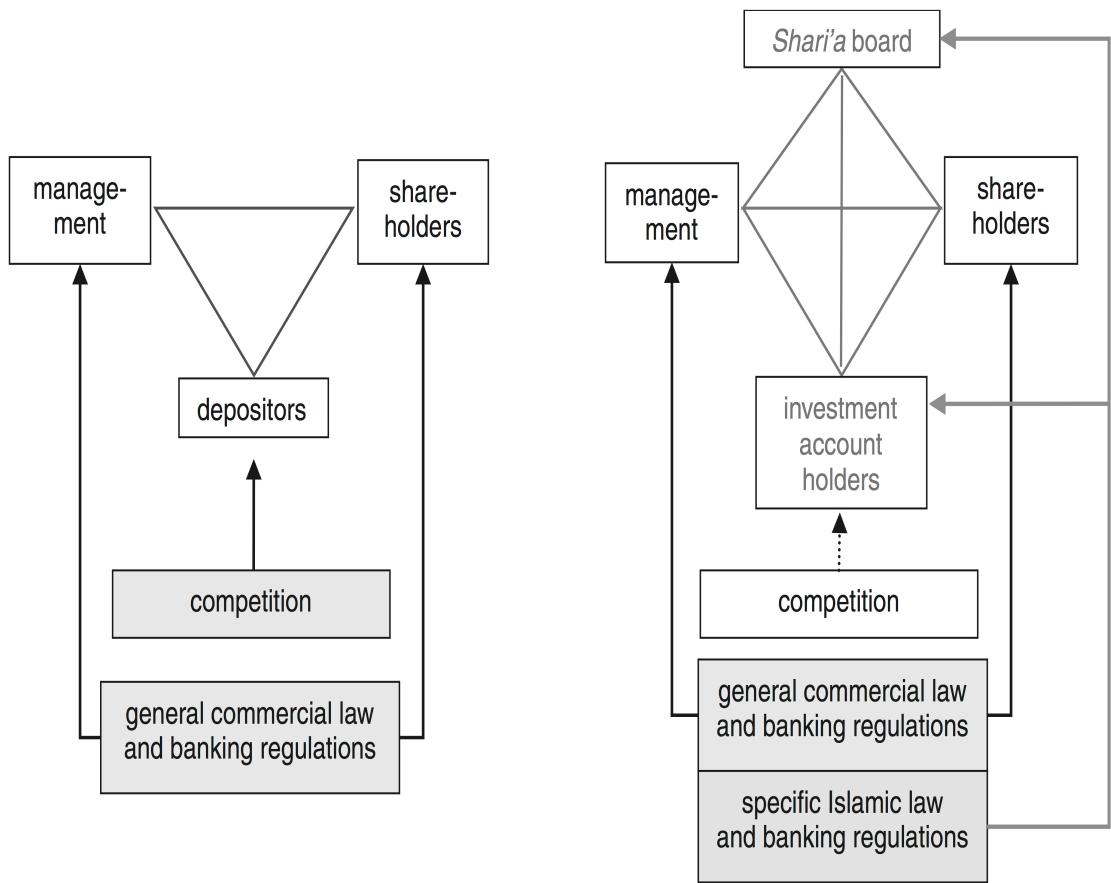
Figure 3: Corporate Governance in an Islamic Bank



[Suleiman, N.M]

The additional body of the governance structure which has no counterpart in conventional banks, namely the Shariah Supervisory Board (SSB). Figure 4 summarizes the stylized governance structures of conventional and Islamic banks.

Figure 4: Stylized governance structures of conventional and Islamic banks



[Handbook of Islamic Banking]

Tawhid and Shura Based Approach to corporate governance

Although as a term 'corporate governance' is comparatively new, the meaning is not new in Islam. The hallmark of Islamic business ethics lies in the great values that support business operations and transactions, along with the practice of justice, equality, truthfulness, transparency, protection of minorities, accountability and adequate disclosure. The three fundamental principles of transparency, accountability and adequate disclosure of the OECD code also underlie good practice in Islam.

Corporate governance includes the nuts and bolts of how corporations ought to achieve their responsibilities to their stakeholders (Hakim, 2002).

Muslim jurists agree on the concept of Tawhid as one of the philosophical pillars of Islamic economics, little is written on the Tawhid epistemological practice on corporate governance, though Choudhury and Hoque, (2004) do review it in their model.

The foundation for the corporate governance framework also originates from this notion of Tawhid (Al-Faruqi, 1982).

Allah says in Quran:

"Those who remember Allah (always, and in prayers) standing, sitting, and lying down on their sides, and think deeply about the creation of the heavens and the earth, (saying): "Our Lord! You have not created (all) this without purpose, glory to You! (Exalted be You above all that they associate with You as partners). Give us salvation from the torment of the Fire"

[Surah 3 Ayah 191]

According to Chapra (1992), this verse provides the central principle of governance where everything created by Allah has a purpose and human being is fashioned to be the world's vicegerent. By putting a trust to mankind as a vicegerent, Allah monitors and is involved in every affair of human being and He is aware and knows

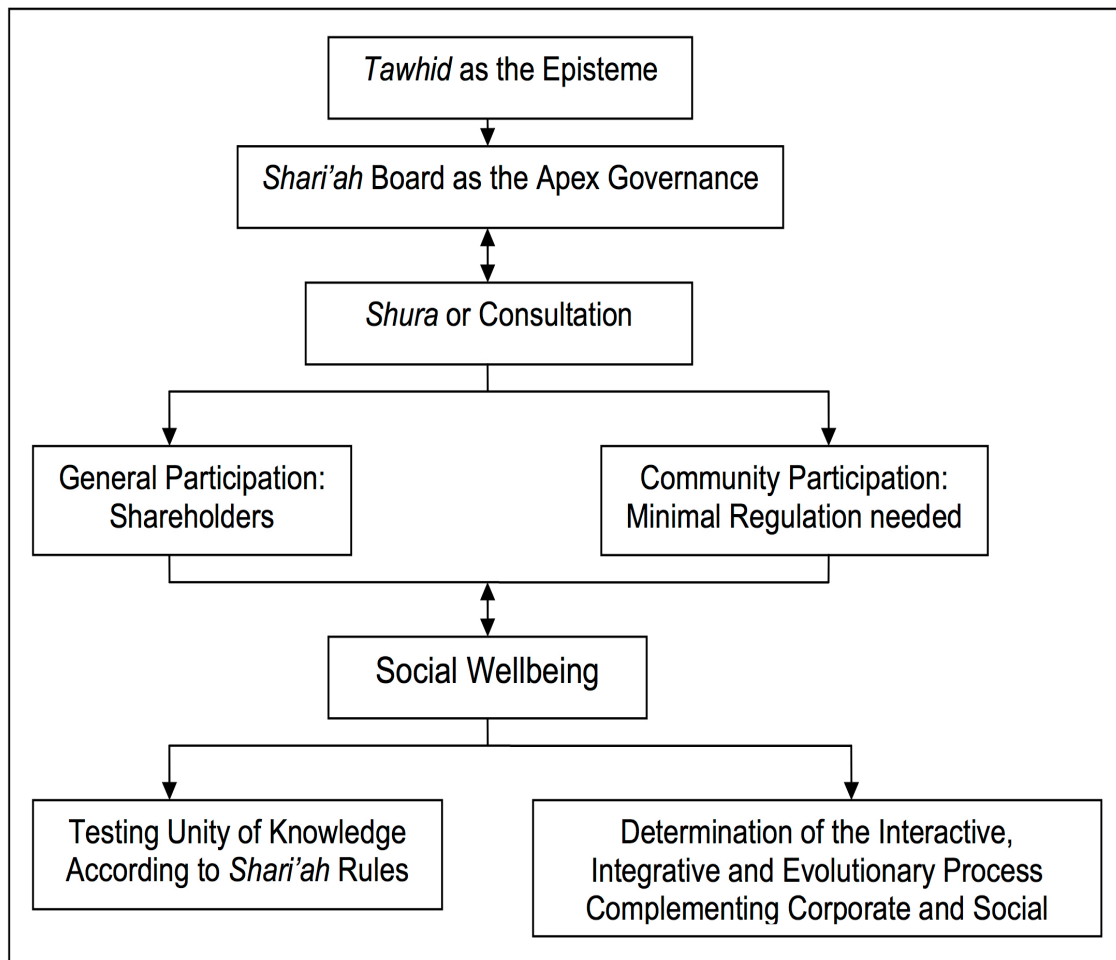
everything all the times. As Allah knows everything and all mankind is accountable to Him, the principle of Tawhid is the basis of the corporate governance model in Islam, as all parties involved are accountable to Allah.

There are four principles and instruments governing Islamic governance:

1. Concept of Tawhid
2. Principle of justice
3. Principle of productive engagement of resources
4. Principle of economic activities and recursive intention of the above

All of these principles are the main foundations of the Islamic corporate governance where the Shariah rules entrenched in the Quran and Sunnah make the Islamic corporation market driven and at the same time support the principle of social justice (Choudury and Hoque, 2004).

Figure 5: Tawhid and Shura based approach Choudhury and Hoque (2004)



[Choudhury and Hoque (2004)]

The stakeholders as vicegerents of Allah have fiduciary duties to uphold the principle of distributive justice via the Shariah process.

There are two main institutions involved in the process of corporate governance:

1. Shariah board
2. The constituent of Shura groups of participants, the stakeholders

The Shariah board plays a crucial role in guaranteeing that all corporation activities are in line with Shariah principles. The shareholders play a big role as active members and mindful stakeholders in the practice of decision-making and policy framework by pondering the interest of all stakeholders rather than maximizing profits.

The community, as stakeholders, must also play their part in offering mutual collaboration to safeguard the interest as a whole and to stimulate the social wellbeing function for social welfare. All of these processes are focused on fulfilling the objective of upholding the principle of distributive justice (Choudury and Hoque, 2004).

The general arguments of offering theoretical foundation of the stakeholder model of corporate governance in Islamic economic system try to establish that the firm's objective is to maximize the welfare of all stakeholders and not the shareholders alone. A comparison of the Anglo-Saxon, the European model and a Shariah based model of corporate governance is shown in the table 1.

Table 1: comparison of the Anglo-Saxon, the European model a Shariah based model of corporate governance

Aspects	The Anglo-Saxon	The European	Shariah Model
Episteme	Rationalism and rationality	Rationalism and rationality	Tawhid
Objective	The Anglo-Saxon	The European	Shariah Model
Rights and Interests	To protect the interests and rights of the shareholders	The right of community in relation of the corporation	To protect the interests and rights of the shareholders but subject to the rules of Shariah
Corporate goal	Shareholders controlling managers for the purpose of shareholders profit	Society controlling for the purpose of social welfare	Acknowledge profit motive oriented but balance it with the Shariah objective and principles
Nature of Management	Management dominated	Controlling shareholder dominated	Concept of vicegerency and Shura
Management Boards	One-tier board	One-tier board	Two-tier board Shariah board as the ultimate governance
Capital related and ownership structure	Widely dispersed ownership: Dividends prioritised	Banks and other corporations are major shareholders; dividends less prioritised	Shareholders and depositors or investment account holders (IAH's)

The above comparison offers a summary of the diverse approaches of corporate governance style and structure. In the characteristic of epistemological method, Islam rejects the rationality and rationalism as the episteme of Shariah corporate governance and replaces it with the episteme of Tawhid.

Table 2 shows Table 1 Alternative Approaches to Corporate Governance

Decision-making basis	Managed corporation model	Socially responsive corporation	Islamic corporate governance
Legal concept of firm: decision- making by whom?	CEO and senior management	Executive and supervisory processes	Shuratic decision-making process: consultation and consensus-seeking
Economic concept of firm: decision-making for whom?	Maximize profits Maximize share-holder value	Stakeholders	Institution of Hisba Role of muhtasib
Accounting concept of firm: decision-making with what resources and to whom is accountability due?	Financial governance by shareholders and suppliers of finance	Corporate responsibility Triple bottom line: economic, social and environmental accountability	Shariah supervision process Religious audit

The above Table summarises the alternative approaches to corporate governance. Shura, Hisba and the Shariah supervisory process and religious audit establish the basic building blocks of a system of Islamic corporate governance. The type of participation inherent in Shuratic decision-making processes offers a medium for guaranteeing that corporate activities and strategies are fully discussed and that a consensus-seeking consultative process is applied. Directors and senior managers are expected to listen to the opinions of other executives before making a decision and Shura members would include, representatives of shareholders, employees, suppliers, customers and other stakeholder parties.

The body of Hisba offers a structure of social ethics, relevant to monitor the corporation, with the objective of encouraging the right ethical behaviour, and also empowers Muslims to act as 'private prosecutors' in the goal of better governance by providing them with a stage for social action.

The Islamic corporate governance objective puts Maqasid Shariah as the final goal and this involves the idea of safeguarding the interest and rights of all stakeholders within the Shariah guidelines. The nature of ownership structure in Islamic corporate governance considers the shareholders and the Investment Account Holders (IAH) as the rightful owners rather than the shareholders alone.

The nature of corporate governance's goal is inclined to the stakeholder model where the governance style focuses on protecting the stakeholders as a whole. The Islamic view of the definition of the stakeholders enhances the understanding past participants in governance of the corporation to the religion of Islam as a whole. The corporate governance model from Shariah viewpoint deems Islam as the ultimate stakeholder alongside the other stakeholders, and puts the Shariah as the governing law of all business matters of the corporation.

Slahudin (2008) investigates the significance of Islamic principles of corporate governance in accordance with the Qur'an and Sunnah, comparing them with the OECD. The Islamic principles of good practice are very similar to the OECD principles; however, they have not been efficiently applied as they have with the OECD principles. The OECD Principles cover six different issues and rights connected to corporate governance, while the Islamic principles have a larger limit and place accountabilities further afield than just shareholders, financiers, suppliers, customers, and employees. The concepts of Shura, Hisba and the Shariah supervisory process along with the religious assessment style the primary building blocks of a system of Islamic corporate governance and business organization (Lewis 2006).

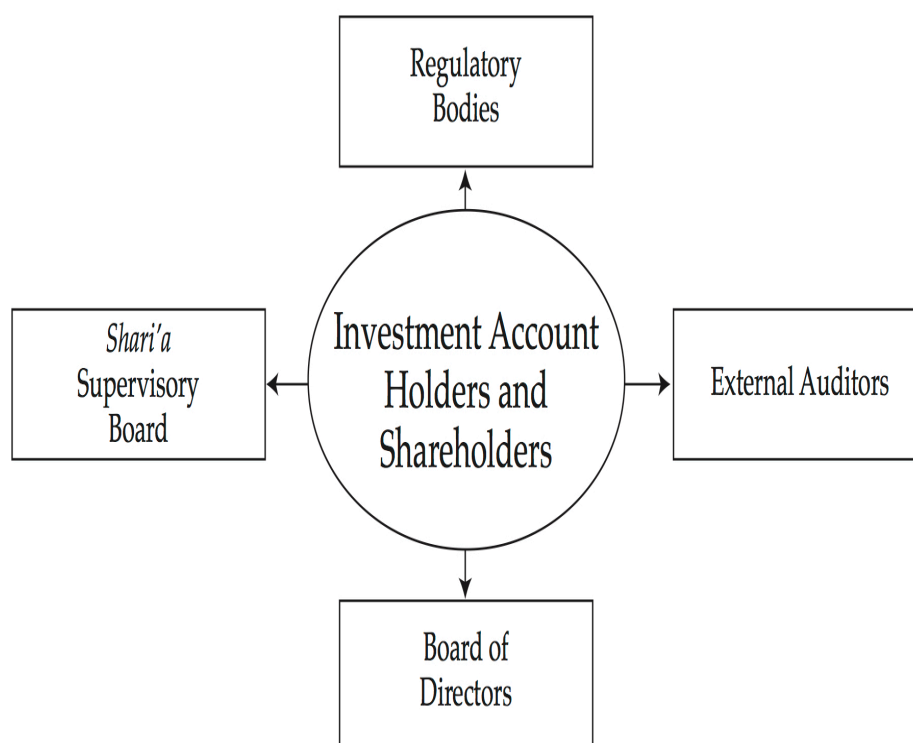
The three basic essentials of the Islamic faith that specify the foundation for corporate governance in Islamic banking (Haron and Shanmugam 1997), are:

1. Aqeedah, belief in Allah
2. Shariah, the law
3. Akhlaq, behaviour, attitude, and work ethic

Regulatory bodies and/or central banks in many countries to enable good

governance practices at Islamic Financial Institutions have established an Islamic corporate governance framework. The vital components of the framework are illustrated in Figure 6 below.

Figure 6: Responsible parties for implementation of corporate governance



[Haron and Shanmugam 1997]

The framework offers standards and guidelines that are in agreement with Shariah; tackles the intermediary and multifaceted roles of Islamic financial institutions; seeks to guarantee accountability, transparency, and a satisfactory division of power among stakeholders; and seeks to avoid conflicts of interest.

Islamic economists and scholars are divided into three groups concerned with which corporate governance approach is best for the future growth of IFIs.

1. The proponents of the European model, the essence of the Islamic corporate governance has a wide commission, with obligations extending beyond shareholders and embracing financiers, employees and customers (Malekian and Daryaei 2010)

2. The proponents of the Anglo-Saxon approach imply that in actual practice, many Islamic corporations adopt the Anglo-Saxon approach (Hasan 2008). They argue that it is for the best of IFIs to work on the adaptation of the Anglo-Saxon approach that also makes it easier for them to enter the western financial world and compete with the existing conventional system
3. They argue that the IFIs' structures are completely unlike to those in conventional corporations, where the depositors in IFIs are also stakeholders and they do not generally get much attention in the Anglo-Saxon as well as European approaches. It is the depositors and not the shareholders who provide a large proportion of funds (Chapra and Ahmed 2002)

Studies seem to suggest that Islamic corporation may adopt a totally different model of corporate governance or a modified version of the Stakeholder-oriented model as an alternative for its corporate governance framework (Hasan 2008).

Chapter 3 Research Methods

Research Methodology

Harmonizing the methodology to the research question is fundamental to any research strength (Punch, 1998).

Johnson and Clark (2006) note, as researchers we must to be cognizant of the progressive pledges we make through our choice of research approaches, since this has significant effect not only on what we do but how we recognise what it is we are exploring. It would be easy to fall into the trap of thinking that one research philosophy is 'better' than another, which would miss the point, as they are 'better' at undertaking different things. Which is 'better' depends on the research question(s) you are looking to answer and the everyday reality is that a particular research question seldom falls entirely into only one philosophical area.

Tashakkori and Teddlie (1998) suggest that it is more proper for the researcher in a particular study to think of the philosophy accepted as a continuum rather than differing views. They note that 'at some points the knower and the known must be collaborative, while at others, one may more simply stand apart from what one is studying' (Tashakkori and Teddlie 1998).

Tashakkori and Teddlie (1998) state that you should 'study what interests you and is of value to you, study in the different ways in which you deem appropriate, and use the results in ways that can bring about positive consequences within your value system' (Tashakkori and Teddlie 1998).

Management research is concerned with the social realm in which we exist, Bhaskar (1989) asserts that as researchers we will only be able to understand what is going on in the social world if we recognize the social constructions that have given rise to the phenomena that we are endeavouring to comprehend.

Our understanding of reality is a consequence of social conditioning and cannot be comprehended distinctly of the social actors involved in the knowledge derivation process (Dobson 2002).

Hakim (2000) using an architectural example links the most suitable choice of research method, where she presents the idea of the researcher's chosen style, which, rather like the architect's, may reflect ' . . . the architect's own preferences and ideas . . . and the stylistic preferences of those who pay for the work and have to live with the final result' (Hakim 2000). This resonates the positions of Buchanan et al. (1988), who supports that 'needs, interests and preferences (of the researcher) . . . are typically over-looked but are central to the progress of fieldwork'.

The research approaches used possibly used for exploratory, descriptive and explanatory research (Yin 2003). However, regularly assigning strategies to one approach or the other is unduly simple, what is most important is not the label that is ascribed to a specific strategy, but whether it will allow the research question(s) and meet the designed objectives.

One of the objectives of this research is to examine, and construct greater awareness of, some of the chief concerns related to corporate governance in Islamic Financial Institutions. A second objective is to offer important Shariah guidelines to develop corporate governance in these institutions and support them to not only maintain their stimulus of growth and international acceptance but also guard the interests of all stakeholders.

Due to the nature of the research and the need to gain views of people from across the world, an electronic survey based approach was chosen as the research method. The survey strategy is usually associated with the deductive approach and is a popular and common strategy in business research and tends to be used for exploratory and descriptive research. Surveys are popular as they allow the collection of a large amount of data from a sizeable population in a highly economical way.

The survey strategy is seen as authoritative by people in general and is both relatively easy to explain and to understand. The survey strategy allows you to accumulate quantitative data that can be analysed and can be used to offer possible reasons for specific relationships between the variables and to produce

models of these relationships.

The data amassed by the survey strategy is unlikely to be as wide-ranging as those collected by other research strategies. For example, there is a limit to the number of questions that any questionnaire can contain if the goodwill of the respondent is not to be presumed on too much. Possibly the biggest disadvantage with using a questionnaire, as part of a survey strategy is the ability to do it poorly.

The issue of the credibility of research findings is expertly articulated by Raimond (1993) when he subjects findings to the 'how do I know?' test: '. . . will the evidence and my conclusions stand up to the closest examination?'

Rogers (1961; cited by Raimond 1993): 'scientific methodology needs to be seen for what it truly is, a way of preventing me from deceiving myself in regard to my creatively formed subjective hunches which have developed out of the relationship between me and my material'.

Reducing the risk of getting the answer incorrect means that care has to be paid to two particular emphases on research design, reliability and validity.

Robson (2002) stresses four threats to reliability:

1. Participant error
2. Participant bias
3. Observer error
4. Observer bias

It is worth mentioning that there are a variety of definitions in common usage (Oppenheim 2000) of the term 'questionnaire'. Some reserve it wholeheartedly for questionnaires where the person answering the question basically records their own answers. Feasibly not surprisingly, the questionnaire is one of the most extensively used data gathering approach. Since each respondent is asked to respond to the same set of questions, it offers an effective way of collecting replies from a large sample before quantitative analysis. Bell (2005) and Oppenheim

(2000) support that it is far more challenging to create a good questionnaire than you might think. You need to guarantee that it will gather the exact data that you need to answer your research question(s) and complete your objectives.

This is important because you are unlikely to have more than one chance to collect the data, where you will be unable to go back to those individuals who want to stay unspecified and collect extra data using another questionnaire.

The design of your questionnaire will affect the response rate and the reliability and validity of the data you collect. Response rates, validity and reliability can be increased by:

- Careful design of questions
- Clear and pleasing layout
- Lucid explanation of the purpose of the questionnaire
- Pilot testing
- Carefully planned and executed administration

Many researchers use a questionnaire to gather data without reflecting on other methods, such as inspection of secondary source observation, semi-structured or unstructured interviews. Questionnaires are normally not good for exploratory or other research that requires large numbers of open-ended questions, and work best with standardised questions that will be understood the same way by all respondents (Robson 2002). Questionnaires, if worded correctly, normally require less skill and sensitivity to administer than semi-structured or in-depth interviews (Jankowicz 2005).

The advantages of questionnaires according to Popper (1959, reprinted 2004):

1. Practical
2. Large amounts of information can be collected from a large number of people in a short period of time and in a relatively cost effective way

3. Can be carried out by the researcher or by any number of people with limited affect to the validity and reliability
4. The results of the questionnaires can usually be quickly and easily quantified by either a researcher or through the use of a software package
5. Can be analysed more 'scientifically' and objectively than other forms of research
6. When data has been quantified, it can be used to compare and contrast other research and may be used to measure change
7. Positivists believe that quantitative data can be used to create new theories and / or test existing hypotheses

The disadvantages of questionnaires

1. Inadequate to understand some forms of information
2. Phenomenologists state that quantitative research is simply an artificial creation by the researcher, as it is asking only a limited amount of information without explanation
3. May lack validity
4. No way to determine truthfulness of respondent
5. No way of telling how much thought a respondent has put in
6. The respondent may be forgetful or not thinking within the full context of the situation
7. People may interpret questions differently
8. There is a level of researcher imposition

Two important considerations have determined my approach in this research. One of these is general in nature and is related to the state of the existing theory and practices of Islamic Financial Institutions, the other consideration is related to the precise aspects of the study.

General considerations concern corporate governance principles and applications for financial institutions, wherever they may be located. Specific considerations, via the empirical study, to identify the common issues facing all Islamic Financial Institutions with regards to corporate governance and provide Shariah based

solutions to them. The detailed considerations apply to Islamic Financial Institutions and Shariah basis, whereas the general considerations can apply to any financial institution.

An empirical study of corporate governance in Islamic Financial Institutions will be undertaken to identify via primary research the issues facing Islamic Financial Institutions. There have been many surveys conducted on corporate governance in conventional financial institutions; empirical studies of corporate governance in Islamic financial institutions are few in number. Those which have been conducted focus attention on specific issues, some of them address the accounting and auditing aspects of corporate governance, whilst others try to determine the overall strategies and investment policies as well as the role of Shariah supervisory boards (SSB's) in the operation of Islamic banks, or compare the behaviour of Islamic and conventional banks.

How the Questionnaire was developed

A survey cannot attain success without a well-designed questionnaire, however, regrettably, questionnaire design has no theoretical basis to guide the researcher in developing a perfect questionnaire. All the researchers have to guide them is a lengthy list of do's and don'ts arising from the experience of other researchers.

A good questionnaire design depends on the data that needs to be gathered; whether that contains qualitative information for the purposes of a healthier understanding or the production of a hypotheses or whether it is quantitative information that analyses current hypotheses.

1. Exploratory questionnaires:

For qualitative or data not statistically evaluated, it may be that no formal questionnaire is required.

2. Formal standardised questionnaires:

If the aim is to investigate and quantify hypotheses and the data is to be

analysed statistically, a standardised questionnaire needs to be designed.

Such questionnaires are generally characterized by:

- Prescribed wording and order of questions
- Prescribed definitions or explanations for each question
- Prescribed response format

There are no hard and fast rules regarding how to design questionnaires, however, there are a number of points that can be kept in mind:

1. Well-designed questionnaires should meet the research objectives
2. They should obtain the most complete and accurate information possible
3. Well-designed questionnaires should make it easy for respondents to give the necessary information and it should be arranged so that sound analysis and interpretation are possible
4. They should be arranged so that the respondent(s) remain interested throughout

Following the investigative phase, two key steps remain to be concluded before the task of designing the questionnaire may begin.

1. To articulate the questions that the research is intended to address
2. To determine the hypotheses around which the questionnaire is to be designed

There are many steps involved in the development of a questionnaire and they include the following:

Decide the information required

Decide 'what are the things one needs to know from the respondent in order to meet the survey's objectives?'

The researcher may already have an idea about the type of information to be collected, but additional help can be obtained from secondary data. The researcher should be aware of what work has been done in the past, what factors have not yet been examined, and how the present survey questionnaire can build on what has already been discovered.

What I did:

I undertook much prior research and examined previous research and surveys in the area of corporate governance and specifically corporate governance in IFI's. I examined the questions that were surveyed and looked at the analysis of results, as well as looking at suggestions for further research areas in this field. I had already formulated an idea on the areas of my research and the data that I wished to gather from previous personal interest, professional work and interactions with Islamic finance researchers.

Define the target respondents

The researcher must define the target market from where they wish to generalize.

What I did:

The target respondents were identified as those individuals who worked in IFI's across the globe. The nature of the IFI was made clear in the survey and included all those who dealt with Islamic finance as part of their business activity. I did not focus on Islamic banks only, but rather included, Islamic finance consultancies, financial institutions, accountancy companies, legal firms and those who have Islamic finance as part of the nature of their business. This allowed the respondents to be a wider net than merely restricting to Islamic banks.

I felt that this would allow a greater number of respondents to be included in the survey, provide a wider range of opinions and more informed and varied points of view. Although, this would make the job of analysis of data more difficult, I felt that doing so, would provide more enriched data for analysis.

Choose the method(s) of reaching your target respondents

The method of reaching the planned respondents ought to comprise part of the questionnaire design process. The method of contact will sway not only the questions the researcher is able to ask but the phrasing of these questions. The main methods available in survey research are:

- Personal interviews
- Group or focus interviews
- Mailed questionnaires
- Telephone interviews

Each has advantages and disadvantages, with a general rule that the more sensitive or personal the information, the more personal the form of data collection should be.

What I did:

Due to the respondents being across international borders and in numerous sectors of the economy, I felt the most logical, practical and achievable and easy to reach my target respondents was through an electronic survey. I felt that personal interviews, group or focus interviews, mailed questionnaires and telephone interviews were just not practical and would not allow efficient and effective data gathering.

I therefore, employed the use of an online survey creation software that allowed me to create an online survey, and then send an invite to my respondents via an email. The respondents were given a unique login username and a password which they used to access the survey and complete it. The respondents were able to access the survey as many time as they chose, allowing them to complete the survey over a number of attempts (if they did not have the time to complete it at one time).

This method was chosen, keeping in mind the factors of geographical locations,

the nature of Islamic finance institutions, as well as the variety of individuals who will be respondents. The nature of the information gathered was not of a personal nature, it was of a professional nature, the need for a very personalised approach was not necessary. Therefore, the respondents were kept anonymous in order to protect their confidentiality and to ensure that no repercussions would be forthcoming from any employer or place the respondent in a precarious position.

Decide on question content

Researchers must always be prepared to ask,

"Is this question really needed?"

The lure to include questions without critically evaluating their impact on the attainment of the research objectives is startlingly strong. No question should be included unless the data it gives rise to is directly of use in testing one or more of the hypotheses established during the research design. There are only two instances when apparently "redundant" questions might be included:

- Opening questions that are easy to answer and which are not perceived as being "threatening"
- "Dummy" questions can camouflage the purpose of the survey and/or the backing of a study.

What I did:

After determining the data that was needed for the research objectives to be achieved, a mixture of question types was chosen and administered in the survey. No redundant questions were employed, in order to keep the survey succinct and precise, as the nature of the respondents demanded this, and the need to employ 'dummy' questions was deemed inappropriate. I felt that the survey did not include irrelevant questions, but, rather questions that I felt were essential and gave rise to valuable data.

Develop the question wording

Survey questions can be categorized into three forms:

1. Closed questions

Advantages

- provides the respondent with an easy method of indicating the answer, and does not have to think about how to express the answer
- Prompts the respondent so that he / she has to rely less on memory in answering a question
- Responses can be easily classified, making analysis straightforward
- Permits the respondent to specify the answer categories most suitable for their purposes

Disadvantages

- Do not allow the respondent the chance to give a different response to those proposed
- They 'suggest' answers that respondents may not have pondered beforehand

2. Open-ended

With open-ended questions the respondent is asked to give a reply to a question in his/her own words, with no suggested responses. Open-ended questions have a number of advantages when utilised in a questionnaire:

- Allow the respondents to answer in their own words, with no influence by any suggested alternatives
- Often reveal the issues that are most important to the respondent, and may reveal findings which were not originally anticipated
- Respondents can 'qualify' their answers or emphasise the force of their opinions

However, open-ended questions also have fundamental problems which means

they must be treated with considerable caution.

- Respondents may find it difficult to 'articulate' their responses
- Respondents may not give a full answer simply because they may forget to mention important points.
- Data collected is in the form of verbatim comments and has to be coded and reduced to manageable categories.
- Respondents will tend to answer open questions in different 'dimensions'

3. Open response-option questions

The advantages of this type of question are:

- The researcher can avoid the potential problems of poor articulation by being able to prompt the respondent into considering particular response
- Recording during interview is relatively straightforward.

The one disadvantage of this form of question is that it requires the researcher to have good prior knowledge of the subject in order to generate likely responses before issuing the questionnaire.

Clearly there are going to be situations in which a questionnaire will need to incorporate all three forms of question, because some forms are more appropriate for seeking particular forms of response. In instances where it is felt the respondent needs assistance to articulate answers or provide answers on a preferred dimension determined by the researcher, then closed questions should be used. Open-ended questions should be used where there are likely to be a very large number of possible different responses, where one is seeking a response described in the respondent's own words, and when one is unsure about the possible answer options. The mixed type of question would be advantageous in most instances where most potential response-options are known; where unprompted and prompted responses are valuable, and where the survey needs to allow for unanticipated responses.

There are a series of questions that should be posed as the researchers develop the survey questions themselves:

"Is this question sufficient to generate the required information?"

It is good practice to keep questions as simple as possible, as the careless design of questions can result in the inclusion of two items in one question. Where it is difficult for the respondent to answer and equally difficult for the researcher to interpret the response.

What I did:

I employed Closed questions, Open-ended and Open response-option questions. This was a situation in which the need to incorporate all three forms of question types was appropriate. The mixed type of question was advantageous as most potential response-options are known, and the unprompted and prompted responses are extremely valuable, and the survey needed to allow for unanticipated responses.

Put questions into a meaningful order and format

Opening questions: Opening questions should be easy to answer and not in any way threatening to the respondents. The first question is crucial because it is the respondent's first exposure to the questionnaire and sets the tone for the nature of the task to be performed.

Question flow: Questions should flow in some kind of psychological order, so that one leads easily and naturally to the next. Questions on one subject, or one particular aspect of a subject, should be grouped together.

Question variety: Respondents become bored quickly and it usually improves response, therefore, to vary the respondent's task from time to time.

Closing questions

It is natural for a respondent to become increasingly indifferent to the questionnaire as it nears the end. Those questions that are of special importance should, if possible, be included in the earlier part of the questionnaire. In developing the questionnaire, the researcher should pay particular attention to the presentation and layout.

- Questions should be clearly worded and response options clearly identified
- Prescribed definitions and explanations should be provided
- Ample writing space should be allowed to record open-ended answers

Check the length of the questionnaire

It is best for a questionnaire to be as short as possible, as a long questionnaire leads to boredom on the part of the respondent.

Pre-test the questionnaire

Even after the researcher has progressed along the lines suggested, the draft questionnaire is a product evolved by one or two minds only. Until it has truly been used in interviews and with respondents, it is impossible to say whether it is going to attain the required results. For this reason, it is necessary to pre-test the questionnaire before it is used in a full-scale survey, to pinpoint any mistakes that need correcting.

The purpose of pretesting the questionnaire is to determine:

- Whether the questions as they are worded will achieve the desired results
- Whether the questions have been placed in the best order
- Whether the questions are understood by all classes of respondent
- Whether additional or specifying questions are needed
- Whether some questions should be eliminated

- Whether the instructions to interviewers are adequate

Usually a small number of respondents are chosen for the pre-test. The respondents chosen for the pilot survey should be broadly representative of the type of respondent to be interviewed in the main survey. If the questionnaire has been exposed to a thorough pilot test, the final form of the questions and questionnaire will have grown into its final form.

What I did:

The survey was pre-tested on personal contacts who worked in the Islamic finance sector and comprised of the target audience for the survey. I chose 5 people who worked in the industry and gauged their feedback on questionnaire type, questions asked, length of survey, clarity of questions, response times, response methods employed, as well as an overall clarity and quality of the survey. The feedback attained was employed to improve the survey, and it was submitted to the same individuals for their feedback, in order to attempt to achieve the perfect survey.

At the same time, the survey was being tested on individuals who were not from the target audience, in order to gauge their feedback and points of view on the survey. It was felt their feedback on the quality of the survey and the view from a 'non-professional' would be invaluable to the survey. This was also incorporated into the survey. Each of the groups in the pre-test provided feedback on 2 separate occasions, each time amendments were made and the survey amended. The researcher feels that the survey was adequately piloted prior to its launch.

Develop the final survey form

A well designed questionnaire is essential to a successful survey, however, the researchers must develop their own intuition with respect to what constitutes 'good design'. A good questionnaire is one which helps achieve the research objectives, provides complete and accurate information, is easy for both interviewers and respondents to complete and is designed so as to make comprehensive analysis and interpretation possible.

Chapter 4: Roles of Stakeholders & their relationships

This chapter is divided into 2 sections:

4.1 Roles of stakeholders and their relationships in conventional

4.2 Roles of stakeholders and their relationships in Islamic fiqh

The division made to highlight the similarity in the relationships between IFI's and conventional companies and then to further highlight the specific roles that Islamic fiqh places on IFI's.

The chapter is an extension of the literature review with respect to a review of the literature of stakeholders and their relationships, yet at the same time establishing the foundations for answering the some of the research questions raised in Chapter 1 earlier.

4.1 Roles of Stakeholders & their relationships

The question of who is, and who is not, a stakeholder has long been a point of dispute. Should stakeholder status be kept for constituencies that have a very close association with the organization? Or, should stakeholder status be broadly implied and take into consideration all of the groups that can affect and be affected by the firm?

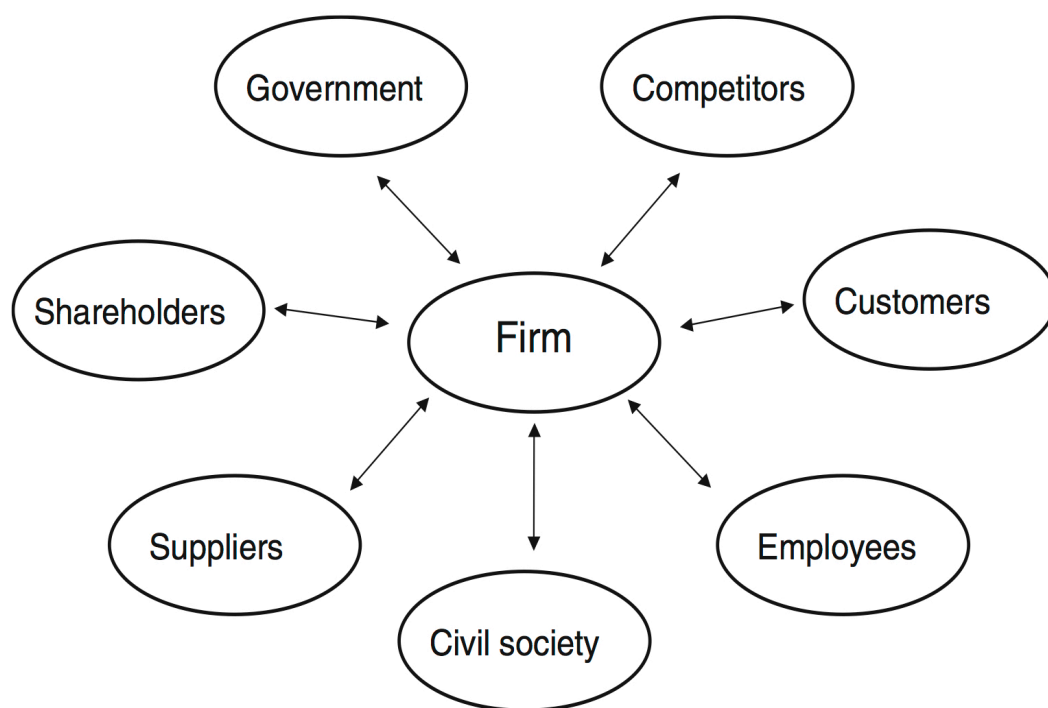
At the least, stakeholders are those from whom the organization has freely accepted benefits, and to whom the organization has subsequently incurred commitments of fairness, such as financiers, employees, customers, suppliers and even local communities. However, some are more contentious contenders for stakeholder status, for example, most firms have not accepted benefits from their competitors or pressure groups, although they can drastically impact the firm's success. Should the firm consider them as stakeholders? And does it owe any commitments to them?

Stakeholder theory maintains that normative stakeholders are owed a commitment

by the firm and the firm's leaders, whereas derivative stakeholders hold power over the firm and may apply either a beneficial or harmful effect on it. Competitors can affect a firm and ought to be considered authentic stakeholders, but the firm and the firm's managers have no moral obligation to attend to their wellbeing.

Freeman's original framework included eleven stakeholders on a non-exhaustive basis (Freeman, 1984); the most common form of the model is characterized in Figure 7 and comprises only seven stakeholders.

Figure 7: The Stakeholder model – Freeman (1984)



Freeman added further groups, markedly pressure groups in a later model and condensed the scheme to five internal stakeholders, Freeman (2003).

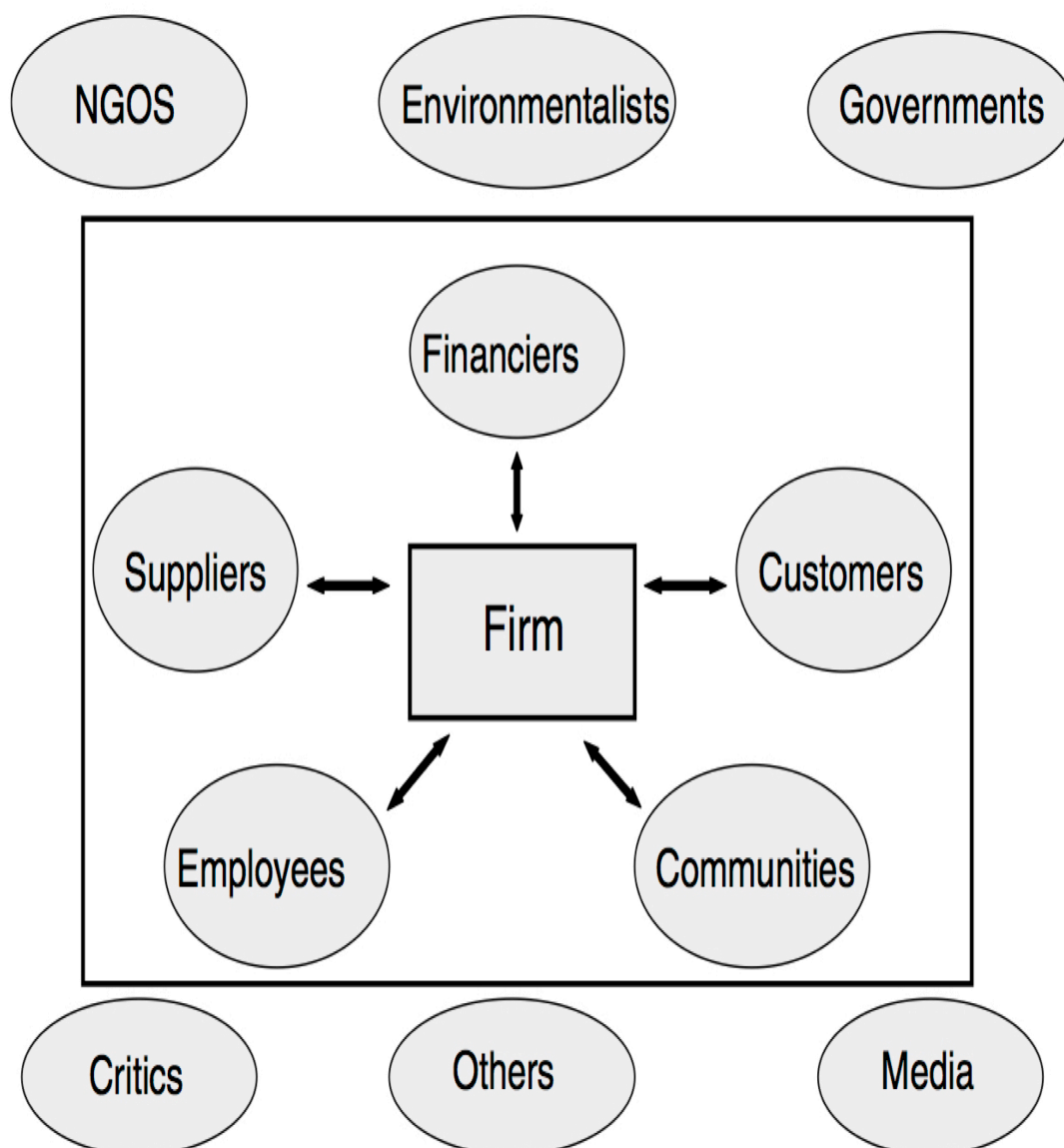
1. Financiers
2. Customers
3. Suppliers
4. Employees
5. Communities (dropping competitors)

He placed a box around the following five stakeholders, and announced six external stakeholders:

1. Governments
2. Environmentalists
3. NGOs
4. Critics
5. Media
6. Others

Without arrows linking these to the central hub, as shown in Figure 8.

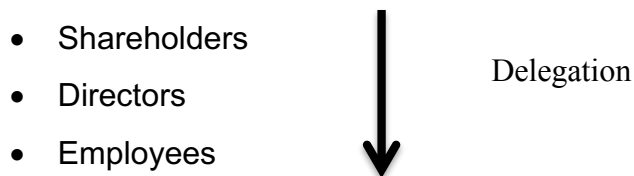
Figure 8: The adapted version of the stakeholder model – Freeman (2003)



What do stakeholders want?

The fact that different people want different things from their relations with organizations makes it difficult to know with sureness what stakeholders are looking for. Stakeholder dialogues often focus on assigning some measure of organizational value or outcome.

The legal position of the incorporated firm is straightforward, and provides for three sets of participants and a line of delegation of authority running from shareholders to directors to management.



A very common way of distinguishing the diverse kinds of stakeholders is to consider groups of people who have classifiable relations with the organization; according to Friedman (2006) there is a clear relationship between them.

The main groups of stakeholders are:

- Customers
- Employees
- Local communities
- Suppliers and distributors
- Shareholders

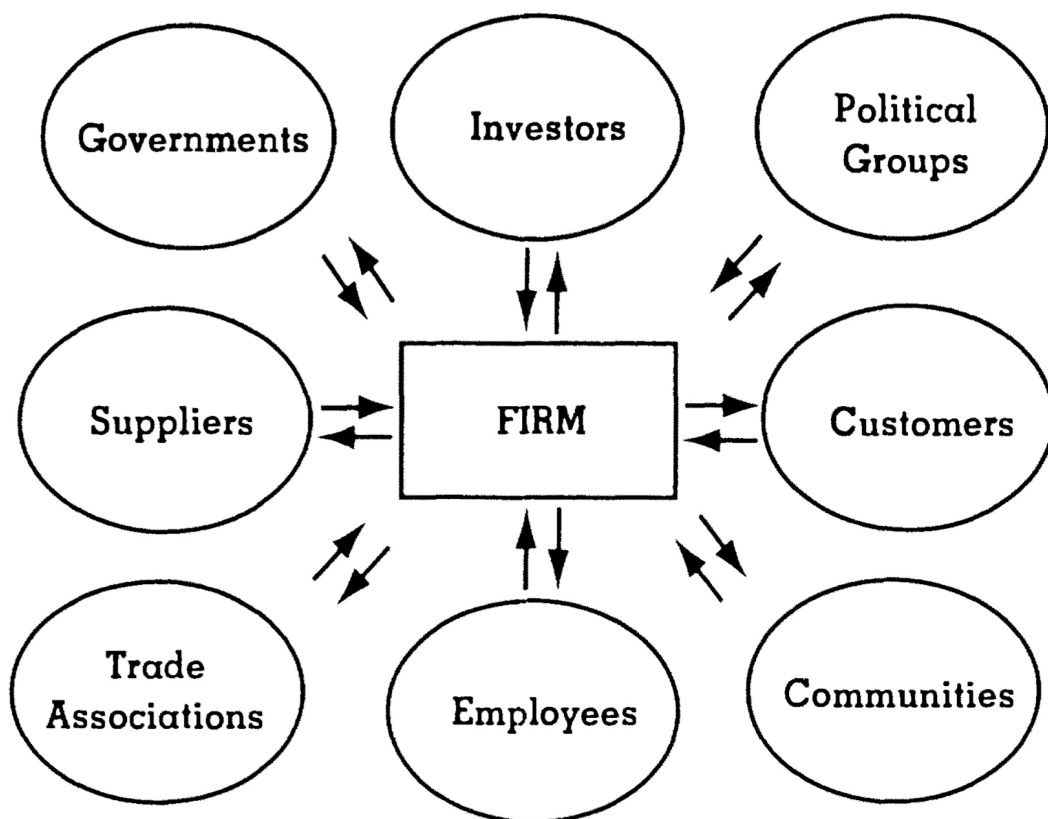
In addition other groups and individuals are considered to be stakeholders according to Friedman (2006):

- The media
- The public in general
- Business partners

- Future generations
- Past generations (founders of organizations)
- Academics
- Competitors
- NGOs or activists
- Stakeholder representatives (trade unions, trade associations)
- Financiers other than stockholders
- Competitors
- Government, regulators, policymakers

The stakeholder model states that all persons or groups with genuine interests contributing in a business do so to gain benefits and that there is no obvious priority of one set of interests and benefits over another.

Figure 9: Contrasting models of the corporation: The stakeholder model



According to Freeman (1984), stakeholders can be viewed as anyone or group who can affect or can be affected by a firm. A narrower understanding could be that stakeholders are seen only as groups who have economic actions with the firms (Lovio in Heiskanen 2004).

Clarkson (1995) terms primary stakeholders as those “without whose continuing participation, the corporation cannot survive as a going concern,” proposing that these relationships are described by mutual interdependence. They can be defined and classified in different ways and have been divided into groups based on the nature of their relationship to the company, along with their expectations from the corporation. The “web of life” view (Capra 1995) envisions corporations as fundamentally relational, that is, as a “system of primary stakeholder groups, a complex set of relationships between and among interest groups with different rights, objectives, expectations and responsibilities” (Clarkson, 1995: 107).

The following are some of the stakeholders in a corporation and their objectives / goals: -

Government.

Authorities have economic interactions with companies and regulate business behaviours to safeguard consumers, they guarantee product standards and ensure legislations are followed in order to protect the rights of consumers and keep them safe from any dangerous actions of companies.

Employees.

They are employed to carry out assigned tasks to realize the company’s objectives, with success depending in large measure on the skill and commitment of the company’s employees. They want stability a safe working environment, good future prospects, job security and to be paid well. They are also the backbone of most corporations, without whom the corporation will find it difficult to stay in business. If the company antagonizes their best employees then customer service will suffer so they need to look after them. If they want to attract and retain top talent at all levels then they have to offer terms and conditions that are attractive, or they will lose them.

Shareholders

Shareholders initial role is to provide the capital a company requires to grow and expand, or in the case of a startup venture, the capital it needs to launch products or services into the marketplace. They want a good return on their investment and future stability of the company, as well as maintaining their investments; otherwise they will take their capital and go elsewhere.

Management

Duty of preserving the health of the company by keeping stakeholder demands balanced, provide the resources that are necessary for the business to function competently, including the employment of workers, identifying suitable premises and procuring machinery, equipment and raw materials. Management must make timely decisions to ensure that the business remains profitable; they must motivate employees to perform well. They want what the employees want, as they are employees, although they may have other types of relationships with the organisation.

Creditors

These could be financiers and organizations that offer the company technical, managerial or marketing information, e.g. banks, insurance offices and investors other than owners. They have business actions with the company but the relationship is not essentially constant and they do not necessarily have routines with the company, Creditors' rights are often protected under contract and backed by collateral of the company.

Trade unions

To protect the pay and working conditions of employees, which maybe achieved by making it easier to communicate with staff and arrange training opportunities.

Customers

Peter Drucker defined the purpose of a company to create customers, without whom the company cannot survive, and so in almost all situations the customer needs have to come first. The customer can always choose to take his / her business elsewhere, customers are the supporters of businesses in the economy,

as they purchase goods and services, support businesses in identifying the goods and services to be produced and identify changing trends in the market. The reason for a company's existence is to provide products or services that meet the needs of their target customers and benefit them in a meaningful way.

Supplier

This includes all the players that are involved during the whole life cycle of the product, e.g. suppliers, distributors, consumers, even recyclers and waste management organisations. The relationship of these interest groups is economic. Ford (1980) suggests that companies pursue relations with others to gain the benefits linked with reducing costs or increasing revenues. By entering into relationships, organizations hope to gain stakeholder satisfaction and loyalty while stakeholders look for quality (Evans & Laskin, 1994).

The local community / society

Businesses must be conscious of the society as a whole, how the business activities affect society and not only those who are customers. The society keeps businesses in check by making them aware of their impact on society. The community provides the skilled workforce that a company depends upon to maintain the company's competitive edge. It is advantageous for the business to have the support of the local community, as they will provide the necessary support or oppose the actions of the businesses.

Future generations

This group includes citizens, local inhabitants, future generations, societal organisations, universities and vocational schools, academics etc. The company can have external impact on these groups, or the groups might be willing to influence the company actions.

Media

Media can be viewed as a distinct group since it is both a stakeholder and information channel used by all other stakeholders at the same time.

Importance of stakeholders

Engaging stakeholders involves establishing good lines of communication between a company and the companies numerous stakeholders and subsequently keeping a productive connection with them. Through this relationship, stakeholders can have their say and the company can listen and respond. Stakeholder theory (Donaldson & Preston 1995; Evans & Freeman 1988; Freeman, 1984) and empirical research (Clarkson 1995) indicate that companies do clearly manage their relationships with their diverse stakeholder groups. The idea of “paying attention to key stakeholder relationships” (Freeman, 1999: 235) has been a key topic in the strategic management literature; greater stakeholder satisfaction is essential for companies in a competitive atmosphere (D’Aveni, 1994). Maintaining relationships are necessary objectives for both the stakeholder and the organization (Dwyer, Schurr & Oh, 1987; Wilson, 1995).

4.2 Roles of Stakeholders & their relationships in Islamic Fiqh

Islamic banking and finance represents a wholesale departure from conventional banking and finance; from the viewpoint of corporate governance, it demonstrates a number of thought provoking distinctive features since equity participation, risk and profit-and-loss sharing arrangements form the foundation of Islamic financing.

These financial arrangements infer rather different stakeholder relations as compared to conventional banking and finance, and as such affect governance structures from the conventional model since depositors have a direct financial stake in the bank's investment and equity involvements. The Islamic bank is subject to an additional tier of governance, since the suitability of the banks investment and financing must be in strict observance with Shariah law and the expectations of the Muslim community. For this purpose, Islamic banks employ an individual Shariah Advisor and / or Shariah Advisory Board, as well as Shariah review unit.

Chapra and Ahmed, (2002) in their research on corporate governance of Islamic Financial Institutions (IFI's) highlight the idea of justly protecting the rights of all stakeholders irrespective of whether they are equity holders or not. This supports

the stakeholder-centered model put forward by Iqbal and Mirakhor, where the governance structures guard the interest and rights of all stakeholders (Iqbal and Mirakhor, 2004). Their opinions are based on the principle of property rights and pledges to contractual agreements that administer the economic and social behaviour of individuals, society and state.

Islam declares that Allah is the sole owner of property, and humans are merely guardians consuming and managing the property in harmony with the Shariah (Iqbal and Mirakhor, (2004)). The principle of property rights unmistakably offers an all-inclusive framework to identify, recognize, respect and protects the interest and rights of every individual, community, the state and corporation.

There are numerous verses of the Qur'an pertaining to the principle of property rights, including:

“Believe in Allah and His Messenger, and spend of that whereof He has made you trustees. And such of you as believe and spend (in Allah's Way), theirs will be a great reward.

[Surah 57 Ayah 7]

Ibn Khatir explains this Ayah in the following way,

“Allah encourages spending from what He has made mankind trustees of, the wealth that you, mankind has, that He has lent you. This wealth was in the hands of those before you and was later transferred to you. Therefore, O mankind, spend as Allah commanded you from the wealth that He entrusted to you for His obedience. Otherwise, He will hold you accountable and punish you for your ignoring what He ordained on you in this regard”

[Tafsir ibn Khatir]

Imam Ahmad recorded that Abdullah bin Ash-Shikhkhair said, "I came to Allah's Messenger as he was reciting

“abundance diverts you”

and saying,

The Son of Adam claims,

"My wealth, my wealth."

But is there anything belonging to you, except that which you consumed, which you used, or which you wore and then it became worn or you gave as charity and sent it forward.

[Musnad of Ahmad bin Hanbal]

The implied meaning of this verse lays down the principle of property ownership where mankind is only deemed as a representative of Allah. Islam recognizes private and society or state ownership, these imply the recognition of individual ownership in corporations as shareholders and Shariah rules provide guidelines to the individual, corporation and the state on how to deal with this property ownership.

Contractual framework is also very unique in Islam.

In the Quran, Allah clearly reminds the Muslims on the principle of fulfilling each of their contractual obligations where,

Allah says in Quran:

“O you who believe, fulfill contracts”.

[Surah 5 Ayah 1]

This verse presents the basic foundation of the idea of a contract that every individual, society, corporation and the state are bound by, and that, which defines the rights, and obligations of the parties.

Ibn Khatir explains this Ayah in the following way,

"Refers to the covenants, meaning, what Allah permitted, prohibited, ordained and set limits for in the Qur'an. Therefore, do not commit treachery or break the covenants. Allah emphasized this command when

Allah said,

"And those who break the covenant of Allah, after its ratification, and sever that which Allah has commanded to be joined"

until,

"unhappy (evil) home (i.e. Hell)."

[Tafsir ibn khatir]

In relation to corporate governance, each stakeholder has a duty to perform his / her contractual obligations in agreement with the terms specified in the contract directly or indirectly.

Who are the stakeholders in Islamic Financial Institutions?

Iqbal and Mirakhor (2004) formulate two tests to determine any individual to qualify as a stakeholder,

- Do they have any explicit and implicit contractual obligations?
- Whether the one whose property rights are at risk due to business exposure of the corporation

In Islam, a stakeholder is the one whose property rights are at risk due to voluntary or involuntary actions of the company. In the event that someone's rights are compromised as a result of a company's operations, that individual, group, community or society becomes a stakeholder.

A saying of Prophet Muhammad (peace and prayers of Allah be upon him)

supports this risk-based definition of stakeholder,

‘A Muslim is the one from whose hand others are safe’

[Sahih Muslim Chapter No: 1 Hadith no: 65]

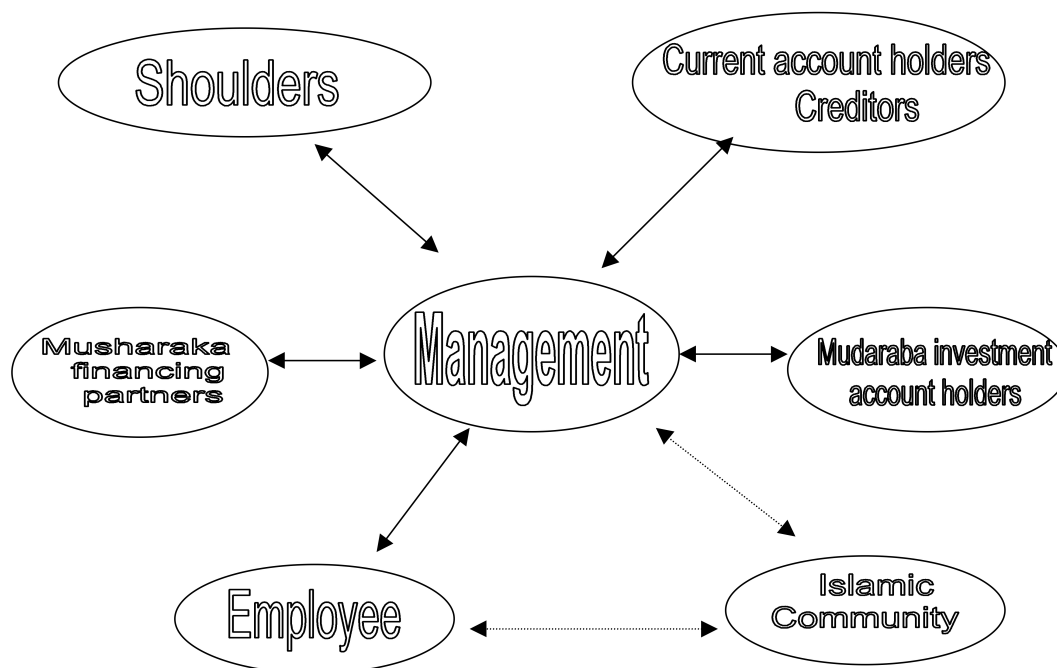
Each element of Allah’s creation has been bestowed with certain rights and duties and each is duty-bound to respect and honour the rights and duties of others. These rights are bundled with the responsibilities for which humans are held accountable. Shariah offers a comprehensive framework to identify, recognize, respect and protect the rights of every individual in creation, community, society, and the state.

The stakeholders are the same as for conventional organisations, with the addition of the following additional stakeholders:

1. Depositors (for banks)
2. Entrepreneur
3. Investment Account Holders (IAH)
4. Shariah Scholars
5. Shariah Supervisory Boards (SSB's)
6. Regulators

Figure 10 illustrates out the key stockholders in an Islamic bank

Stakeholders in an Islamic Bank



[Suleiman, N.M]

Role of Stakeholders in Islamic Financial Institutions

In considering an Islamic view of the role of stakeholders, it is noted that two fundamental concepts of the Islamic economic system pertaining to property rights and contracts govern the economic and social behaviour of individuals, society and the state. These two principles dictate the objective function of economic agents, including legal entities like firms.

Islam's framework of property rights and contracts also establish guidelines regarding who can qualify as a stakeholder, and if such a stakeholder has rights to influence the firm's decision-making and governance. In a very broad sense, any group or individuals with whom firms have any explicit or implicit contractual obligations qualify as a stakeholder even though firms may have formal contracts with them through mutual bargaining. Islam's recognition and protection of rights is not limited to human beings only but encompasses all forms of life as well as the environment.

The following Hadith reflects the importance of being conscientious and mindful of the rights of other stakeholders and the significance of discharging the responsibilities associated with such rights,

'So give to everyone who possesses a right, his right'

[Bukhari: Abu Dawud: Tirmidhi: Ibn Majah]

The term 'right' denotes something that can be justly claimed, or the interests and claims that Shariah may have granted people. The **first axiom** of property rights in Islam is that Allah reserves the right to stipulate for man the rules governing the property while it is in the temporary possession of man as Allah's viceregent. The **second axiom** of the right of possession is a collective right and individuals can only earn a priority in the use of these resources. This proposition becomes a legislative basis for requiring preservation of society's well-being and interests. This **second axiom** implies that while the individual's possession of these resources and his share in the outcome is allowed, sanctioned and protected by the Shariah, it is so as long as it does not come into conflict with society's interest

and wellbeing. This is endorsed by the saying of the Prophet (peace and prayers of Allah be upon him) stating that:

‘Muslims’ blood, property and dignity are protected against each other’.

[Imam Nawawi's 40 hadith Chapter No: 1, Hadith no: 35]

Within property rights framework, one has contractual obligations to others including the community and the society according to the rules of Shariah and honouring of this obligation is considered a sacred duty.

Some stakeholders may derive little benefit from the set of rights negotiated by shareholders and therefore would prefer other safeguards for their interests. Consumers, for example, instead of seeking a seat on the board of directors, or the benefit of fiduciary duties may settle for manufacturers' warranties, consumer and product safety laws, and tort liability system because these protections better serve their interests.

In Islam the expected behaviour of a firm would not be any different from the expected behaviour of any other member of the society. Since the firm itself does not possess a conscious, behaviour of the company's managers becomes the behaviour of the firm and their actions are subject to the same high standards of moral and ethical commitment expected from a Muslim. The managers acting on behalf of the owners shape the firm's economic and moral behaviour and it becomes their fiduciary duty to manage the firm as a trust for all the stakeholders and not for the owners alone. Accordingly, it will be incumbent upon managers to ensure that the behaviour of the firm conforms to the principles and the rules of the Shariah.

The rights that are claimed for stakeholders are not ends in themselves, which ought to be recognized in any form of economic organization, but means for protecting constituency rights. In an Islamic system the observance of rules of behaviour guarantee internationalization of stakeholder rights.

The stakeholders in conventional organisations also apply to Islamic financial

institutions with the addition of additional stakeholders, due to being Shariah complaint organisations.

Depositors

Depositors' want their money to be safely kept by the bank and the value of their money to be safe over time. They do not wish to earn interest; neither do they wish the bank to use their funds to generate interest, as it is impermissible for them as Muslims. However, they would like to have their money returned to them as they have deposited it. In the case of banks experiencing problems, they want their money to safely be returned to them.

Entrepreneurs

They would like to become Musharaka partners for example, or partners in any other halal business manner. They would like the bank to invest the banks money into such partnership agreements, or facilitate a way where the banks provide funds from themselves or from one of its clients.

Investment Account Holders (IAH's)

Within Islamic banks, depositors are exposed to a much higher risk than in conventional banks. Funds credited to customer accounts in Islamic banks are legally not deposits, the characteristic of a deposit is the unconditional claim for full repayment of the principal amount, in Islamic banks, this claim holds true only for money paid into current accounts. Which do not generate any income for the account holders. Shariah compliant accounts, which are intended to generate an income are not vested with an unconditional claim for full repayment, and Investment accounts are based on a Mudaraba type of contract implying a participation in the financial results of the employment of the funds be it profit or loss.

Islamic banks operate on the principle of profit and loss sharing; the funds contributed by the Investment Account Holders are in part, equity investments. Investment Account Holders lack some of the rights that a shareholder enjoys, even though they are a type of equity holder with residual claims to their share of the bank's assets (Archer, Abdel Karim, and Al-Deehani 1998).

An Islamic corporate governance framework should encompass the interests of all stakeholders, including the fair treatment of minority shareholders and Investment Account Holders at Islamic banks. The governance framework should encourage transparency and disclosure regarding decision making in all areas of an institution's professional competence, which is of paramount importance to Investment Account Holders because their funds are normally pooled together with those of shareholders. The framework prescribes disclosure rules, firewalls to protect against conflicts of interest, and sanctions for breaches.

Shariah Scholars and Shariah Supervisory Board (SSB)

They want to ensure that the products on offer are Shariah compliant, as the customers rely upon the judgements of the Shariah board and Shariah scholars. They would also like to be remunerated for their work and experience.

Regulators

Same in Islamic finance and conventional finance, except in Islamic finance they can be more than just one body, as they need to be Shariah complaint is a necessity.

In Islamic banks, there is a conflict of interest between Islamic depositors and shareholders, as both parties share the bank's profit, which implies a distribution conflict. An employee would be expected to contribute his or her knowledge to the formulation and implementation of the organizational vision and the consultative procedures should be applied to all affected parties, for example, shareholders, suppliers, customers, workers and the community at large (Baydoun et al., 1999).

Besides the implementation framework, Islam is very clear on the principles of corporate governance:

“And consult them on affairs [of moment]. Then, when you have taken a decision, put your trust in Allah.”

[Surah Al Imran Ayah 159]

“Those who respond to their Lord, and establish regular prayers; who

[conduct] their affairs by mutual consultation; who spend out of what We bestow on them for sustenance.”

[Surah al-Shura Ayah 38]

Allah’s Messenger (PBUH) said:

“None of you truly believes until he loves for his brother what he loves for himself.”

[Reported in al-Bukhari and Muslim]

The above verses and the hadith stress consultation with stakeholders at the time of decision-making and giving equal importance to all stakeholders (including minority shareholders). The OECD principles do not at any stage take into consideration the keynote emphasis on trusting in God. The process of decision-making is also different from what the OECD envisages, Islam praises consultation and seeking consensus of stakeholders, whereas the OECD principles empower the Board of Directors and / or senior management to make the decisions.

Chapter 5: Survey to identify Corporate Governance issues facing Islamic Financial Institutions

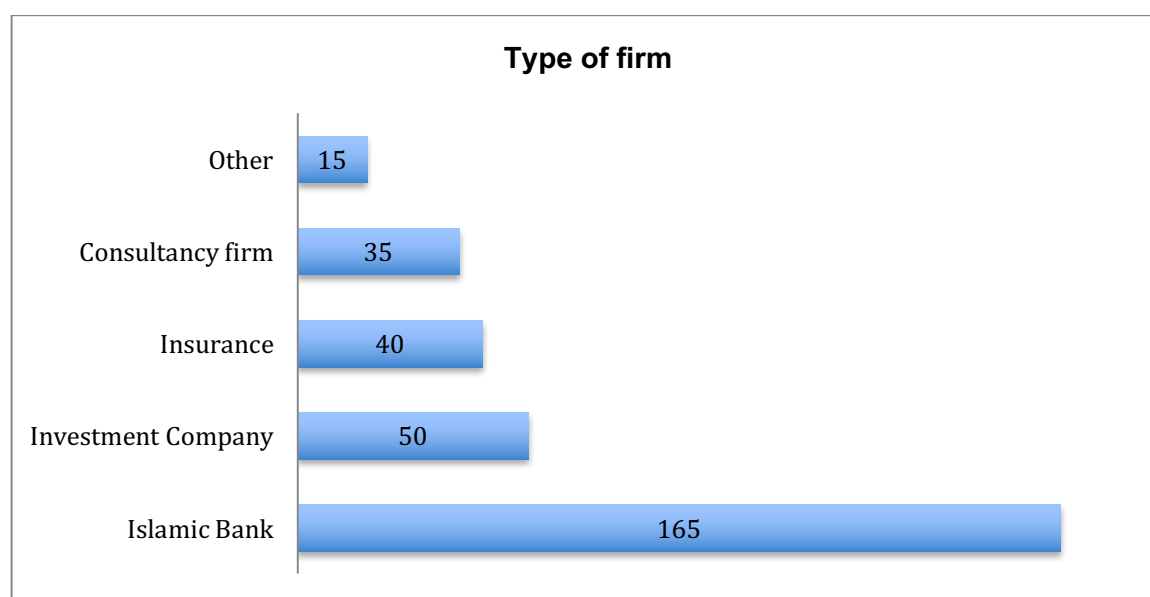
The researcher acknowledges the huge complexities that qualitative researchers face from selecting the research design, to analysing the enormous quantity of data and to articulating how the findings from the data can best be foregrounded.

Analysis of Survey

In discussing the results of the survey questions, the researcher will link the responses to the research question, the research objectives and the literature review. This will be undertaken on a question by question basis and no generalisation will be made.

There were a total of 305 responses to the survey administered online with a 100% completion rate for the questions asked, provided the question was applicable to the respondent.

The respondents were from the following types of organisations:

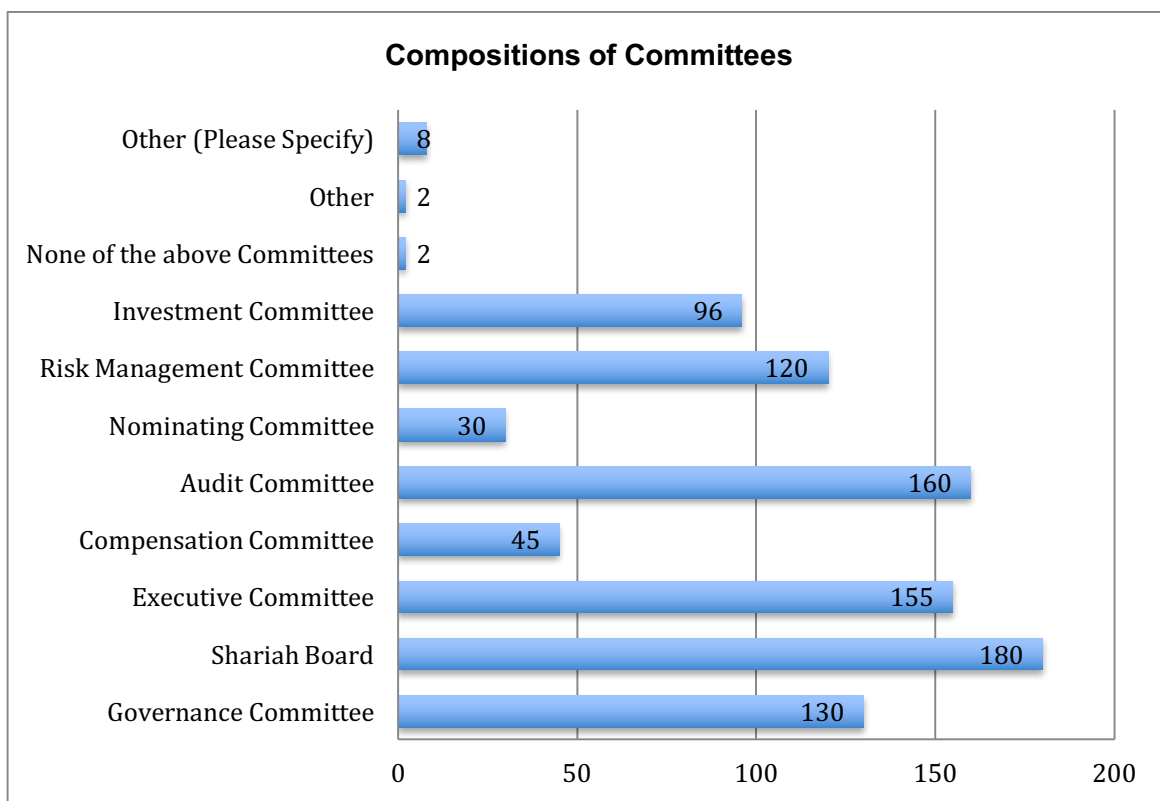


The 'Other category', as per the responses of the respondents includes:

- Manufacturing
- Commercial bank

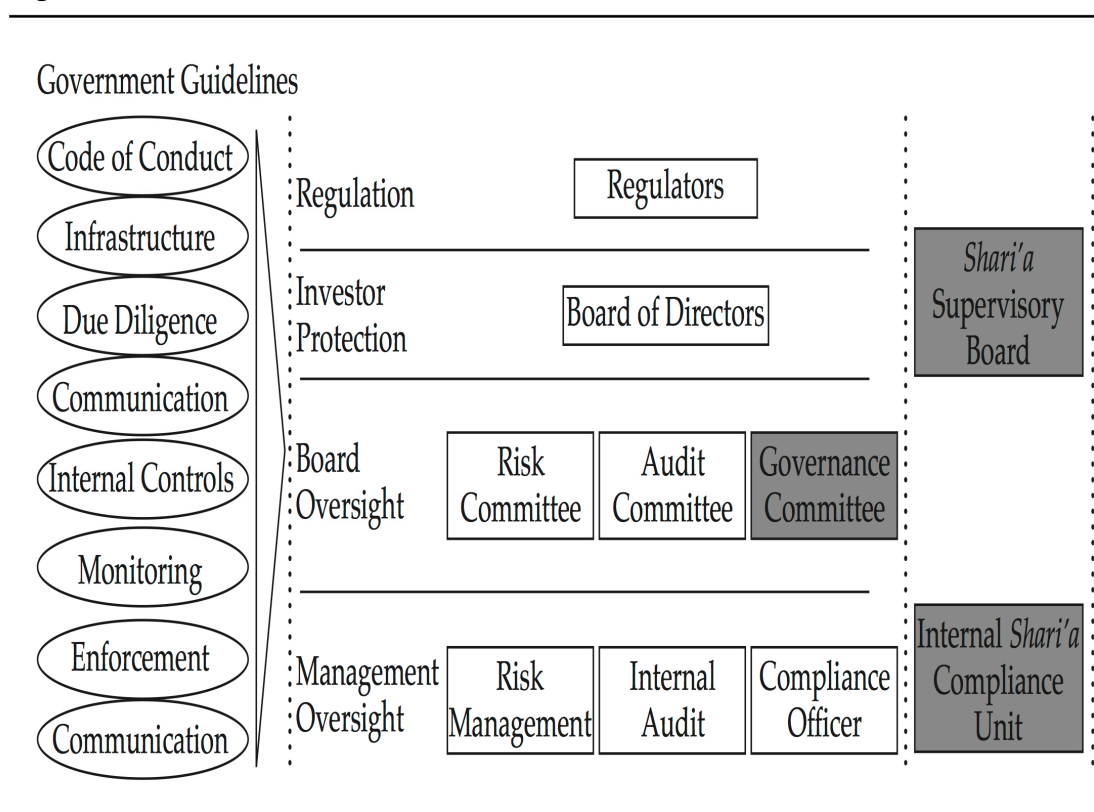
- Islamic University
- Islamic Multilateral development financial institution with subsidiaries for insurance, trade finance, equity fund & private sector financing
- Non-bank lending organisation
- Educational charity
- Training firm
- Non-banking lending organisation

Of these companies, they had the following compositions of committees:



In the 'other' category, the committees included asset management, Human Resources (HR), Shariah compliance and asset liability management. Of the respondents 43% agreed that Institutional investors should be more involved in corporate governance activities, whereas only 2% said that Institutional investors are too involved in Corporate Governance activities and 15% said that Institutional investors should not be involved in Corporate Governance activities.

Figure 11 below depicts the recommended governance structure for a typical Islamic Financial Institution



Source: Stanley (2008).

It is clear that the committees recommended by Stanley (2008) in the above figure, all existed in the institutions respondents in the survey conducted. One of the research questions posed was, "How does the Islamic Corporate governance approach compare with the conventional approach to corporate governance", from these responses it indicates that approaches are similar from this context, as they have similar committee structures. The fact that the committee structures are similar indicates that there is correlation in the thought processes for both conventional and Islamic corporate governance.

The Chairman of the board & CEO were held by the same individual for 36% of the organisations in the survey with only 2% of the respondents skipping the question as not applicable and 62% said that the positions were held by different individuals. According to Williamson (1985), shareholder benefits will be preserved only where separate individuals hold the CEO and the chair of the board.

One of the key elements of corporate governance in terms of boardroom independence and objectivity is the separation of the roles of the Chairman and Chief Executive Officer. Basel II and the OECD Principles of Corporate Governance offer explicit recommendations on this separation, which is likely to lead to further strengthening of the Board's objectivity and independence from management.

Survey Question: In only 9% of the organisations in the empirical study, the board conducted a formal periodic assessment of the board or director performance, whereas in 63% of them an informal assessment was undertaken, 8% did not know and 20% said there was no assessment of the board or director performance. The director has received delegated power and therefore needs to give account and redress faults and shortcomings. Accountability aims for the formation of a network of complementary and corresponding checking mechanisms (Majone, 1994).

The research summary problem of, "Islamic Financial Institutions need to appreciate the importance of good corporate governance", is clearly indicated from these responses. It is clear that the organisations surveyed did not demonstrate this good practice of corporate governance by not conducting a formal periodic assessment of the board or director performance. And the secondary research objective, "Do all the IFI's face similar problems across the globe, or are these problems regional", it seems that this is an international problem for IFI's and is not regionalised.

Behn (2001) noted the view of accountability is more widespread now and properly structured accountability arrangements can provide legitimacy and improve agency governance and performance. The fiduciary duty of directors under most legislation is to do what is best for the company (Monks and Minow, 2004).

Survey Question: The composition of the Shariah board ranged from 2 through to 8, with the majority of respondents (65%) indicating 3 members on the Shariah board. Of these organisations, 80% of the Shariah board members hold positions on other Boards, 7% being on this board only, 10% did not know how many boards the Shariah members were on and 3% did not ask.

According to IFSB Principle 17:

“For the Sharia board to have at least three members, possibly trained in different schools of jurisprudence, have a mix of members with different lengths of experience, and where appropriate, comprise of different nationalities In addition to their Shariah expertise, members of the Sharia board should possess some exposure in the areas of commerce or finance – for example, in retail banking, Takaful undertaking or capital market products. “

[IFSB, 2009]

It is interesting to explore the breakdown of Islamic financial institutions and the Shariah scholars associated with them, for example:

The top 5 out of 176 scholars Shariah Scholars are:

- Sheikh Nezam Yacoubi (77 positions occupied)
- Sheikh Dr Abdul Sattar Abu Ghuddah (72 positions occupied)
- Dr Mohamed Ali Elgari (64 positions occupied)
- Sheikh Abdullah Sulaiman Al Manee'a (37 positions occupied)
- Dr Abdulaziz Khalifa Al-Qassar (37 positions occupied)

[Source: Shariah Scholars in the GCC – A Network Analytic Perspective RELOADED “This 2nd summary report (as of 01 September 2009) prepared by Funds@Work AG]

These scholars make up at least 15% of almost 956 board positions; many of the scholars are active for consulting companies, which cater for the needs of banks, mutual funds, as well as asset management companies.

Gulf cooperation Council (GCC) Shariah board composition,

The top 6 scholars in some of the GCC countries:

1. Bahrain (out of 51) occupy 48.21% of 195 board positions

2. Kuwait (out of 45) occupy 48.23 % of 226 board positions
3. Qatar (out of 24) occupy 56.14% of 57 Board positions
4. Saudi Arabia (out of 37) occupy 61.42% of 127 board positions
5. The top 6 scholars in the UAE (out of 31) occupy 52.67% of 150 board positions
6. The top 10 scholars in the whole of GCC (out of 138) occupy 46.09 % of 755 board positions

The top 10 scholars (out of 138) in the GCC make up 46% of 755 board positions (occupying 348 positions) they are:

- Shaikh Nedham Mohamed Saleh Yacoubi
- Shaikh Dr. Abdul Sattar Abdul Karim Abu Ghuddah
- Dr. Mohamed Ali Elgari
- Sheikh Abdullah Sulaiman Al Manee'a
- Dr. AbdulAziz Khalifa Al-Qassar
- Dr. Hussain Hamid Hassan
- Dr. Essa Zaki Essa
- Sheikh Dr. Ajeel Jasem Al-Nashmi
- Dr. Mohammad Daud Bakar

The numbers indicate that about 68% of all Shariah board positions throughout the GCC are shared by only 11 of the active scholars

1. 94 scholars on 467 board positions: estimated 5 board positions per scholar
2. Disregarding all scholars with less than 3 actual board positions leaves 400 positions for 38 scholars leading to 10.5 expected board positions per scholar
3. The Top 10 scholars (15 or more positions) share 253 positions leading to 25.3 positions per scholar

[Source: Shariah Scholars in the GCC:
A Network Analytic Perspective RELOADED]

According to IFSB principle 1.1:

“Ensuring that the Shariah board is more focused, with more time spent on each assignment and conflicts of interest adequately managed, which may imply that its members should not serve more than a limited number of clients”

[IFSB, 2009]

The IFSB is clearly worried with the conflict of interest issue, and further adds in the footnote to the guiding principles (2009),

“It is important to ensure there are appropriate firewalls that can neutralise any potential conflicts. For example, it may be acceptable for a Shariah scholar to become a member of the Shariah board for IIFS operating in different segments of the IFSI or in different jurisdictions.”

The author questions how individuals on so many boards can actually undertake the work effectively, especially when so many of them have other work alongside this, for example lecturing at universities?

The author further questions how the IFSB principle 1.1, sub section 19,

“should not serve more than a limited number of clients”;

is adhered to by these scholars occupying so many positions?

Does being on 30 + positions of Shariah fall with ‘the limited number’ and is it adequate according to the IFSB? How about 50+ Shariah boards?

Being on some many boards must surely, by simple logic, lead to a conflict of interest? Is it possible for any individual to be present on the board of 30+ Shariah boards of Islamic financial institutions and keep each boards information confidential from the other? So many Shariah scholars are on different boards

together, is it possible to keep the information confidential under such circumstances?

The primary research objective of:

- To identify the specific corporate governance issues / problems facing IFI's. Does an Islamic way of life provide a solution to these corporate governance issues / problems?
- To identify specific Shariah related corporate governance issues / problems. How do Islamic principles, if at all, apply to corporate governance? Why is it that these problems exist for IFI's is there are Islamic principles that do provide a solution?
- To identify potential solutions for these issues / problems from an Islamic angle. Are there guidelines setup that provide solutions from Shariah principles? Who has set them up and why do these problems still persist?

It is clear that these are all being overlooked or simply ignored by IFI's, even when there are clear guidelines from IFSB, which are binding upon those companies who are located in certain countries.

The Islamic Shariah clearly provides guidelines in dealing with the following research questions posed,

- How do Islamic principles apply to corporate governance?
- What regulations and guidelines does the Shariah provide to regulate corporations?

The problem arises in the concerned parties following such guidelines from the Shariah and bodies such as IFSB.

Survey Question: In the organisational survey, 7% of the Shariah Board members were employees of the organisation and 69% were consultants, 5% did not know and 19% indicated another relationship or it was not applicable to them. When a

Shariah board member is an employee of the organisation, a potential conflict of interest may arise, whereby the role as an employee of the company conflicts with that of the Shariah board member. The role as an employee requires that the employees work towards achieving the success of the business, whereas the role of the Shariah board is to ensure that the products are fully Shariah compliant, these could be conflicting. For example, if the Shariah board does not approve a product, then it may affect the organisation in a negative manner, and may face undue pressure from superiors at work to ensure Shariah compliance to safeguard company interests.

It would seem that the best relationship is where the Shariah board member is not an employee of the organisation in order to avoid any potential conflicts of interest.

The prophet (peace and prayers of Allah be upon him) said,

“Leave what makes you doubtful for what does not.”

[Related by Tirmidhi & Nasai]

Yet again the Islamic Shariah clearly provides guidelines in dealing with the following research questions posed,

- How do Islamic principles apply to corporate governance?
- What regulations and guidelines does the Shariah provide to regulate corporations?

However, there seems to be a disconnect between the Shariah guidelines and the adaptation of them by IFI's.

Survey Question: In 2% of the organisations, the board conduct a formal periodic assessment of the Shariah Board, whereas 23% conducted an informal assessment and a staggering 60% did not undertake any assessment and 15% did not know whether there was such an assessment of the Shariah board. According to Behn (2001), accountability will provide legitimacy and improve governance and

performance. The fiduciary duty of the directors to ensure the best for the company entails that the directors must assess the performance of the Shariah board.

According to IFSB Principle 2.3:

“There should be a formal assessment of the effectiveness of the Shariah board as a whole and of the contribution by each member to the effectiveness of the Shariah board. “

and sub section 36.

“IIFS shall specify and adopt a process for assessing the effectiveness of the Shariah board as a whole, as well as the contribution by each individual member to its effectiveness. Members of the Shariah board shall be notified of this assessment process at the time of their appointment, so that they have a precise idea as to what is expected of them. “

and subsection 39:

“The performance assessment report should be submitted to the BOD for observation and constructive comments. Where appropriate, IIFS shall act on the results of the performance evaluation, such as considering nominations of new members to be appointed to the Shariah board or seeking the resignation of any member of the Shariah board who fails to meet adequately the terms and conditions of his or her contract. “

[IFSB, 2009]

How is this possible? Organisations signed up to IFSB principles simply disregard them.

The above survey question and its responses deal with the following research questions posed:

- What does the Islamic system of life mean for corporate governance of financial institutions?
- How do Islamic principles apply to corporate governance?
- What regulations and guidelines does the Shariah provide to regulate corporations?
- How does the Islamic Corporate governance approach compare with the conventional approach to corporate governance?
- Is there a convergence in the approaches to corporate governance (Islamic and conventional) or is there divergence?

There are Shariah principles, there are guidelines from IFSB for regulation, there is a clear understanding of good corporate governance. The IFSB principles are clearly grounded in the Islamic way of life, as guidelines from the Prophet Muhammad (peace and prayers of Allah be upon him) provide sound advice for corporate governance issues relating to doubtful matters. There is clear convergence in the problems facing both conventional and Islamic financial institutions, however there is a divergence in how these problems are being tackled, it seems.

Survey Question: In 3% of the organisations, the board conducted a formal annual performance review of the Shariah Board, 4% an informal review, 85% did not undertake any review and 8% did not know.

For 3% of the organisations the board set specific annual performance goals against which the Shariah Board was evaluated, 76% did not and 21% did not know. This is not good practice since in order to undertake an evaluation of the Shariah board there must be clear targets set against which the Shariah board is evaluated. The board ought to be dealt with in a fair and just manner and held accountable to the performance targets that have been set, if targets have not been set against which they will be evaluated, then either party may be deficient. Either injustice will be done to the board, whereby they are held accountable unfairly or the board will not undertake fully the duties that it should as they have not been clearly laid out.

Allah says in the Quran:

“Verily, Allah orders justice”

[Surah An-Nahl Ayah 90]

Ibn Al-Qayyim said,

“Allah the Exalted has made clear in his law (Shariah) that the objective is the establishment of justice between His servants and fairness among the people, so whichever path leads to justice and fairness is part of the religion and can never oppose it.”

[Source: Turuq Al-Hukmiyyah 13]

According to IFSB sub section 21:

“Principles of good governance, prudent risk management and professionalism require the appointment of the Shariah board to be made formally in writing and with the **terms of reference clearly set out**. The appointment letter, which becomes the contract for service for the members appointed to serve on the Shariah board of the IIFS, is the primary document that determines the form of relationship, level of fiduciary duties, and **chain of accountability** between the Shariah board, the IIFS and its stakeholders. As it is legally a binding contract between the two parties”

[IFSB, 2009]

IFSB principles provide robust guidelines.

From the respondents, 33% of the board members in the firm were also on the Shariah board. The question of a potential conflict of interest again arises, as the responsibilities and duties of the board members and the Shariah board members are conflicting.

The above results address the following research questions posed:

- Islamic Financial Institutions need to comprehend the objectives, role and purpose of the Shariah
- Islamic Financial Institutions need to appreciate the importance of good corporate governance
- Identify the problems that the organisation is facing with regards to corporate governance issues that are specifically related to the Shariah

It is clear that the IFI's either do not comprehend or simply choose to ignore the purpose of the Shariah, which in turn is undermining the importance of good corporate governance and raising the specific problem of conflict of interest of Shariah scholars and advisors.

Survey Question: For 8% of the organisations the board had some form of Shariah Board succession plan and a staggering 92% did not. It is clear that organizations need to plan for talent to assume vital leadership positions or backup positions on a temporary and permanent basis. Leadership succession is of fundamental importance in strategic management and research shows that many CEOs are unwilling to step down (Boeker, 1992; Ocasio, 1994), and that unexpected and poorly managed successions have an adverse impact on shareholder wealth (Beatty and Zajac, 1987; Worrell and Davidson, 1987). Succession planning and management ought to support strategic planning and strategic thinking, without it, organizations will struggle to sustain leadership continuity or find appropriate leaders when a change in business strategy is needed.

The fact that only 8% of the organisations surveyed had some form of Shariah board succession plan, shows that unexpected events may lead to a void in the Shariah board, which could lead to a hasty attempt to fill the void with personnel who are inadequately qualified and experienced to undertake the roles. This can possibly lead to a lack of confidence in the Shariah board, and henceforth in the decisions of the Shariah board, thus a loss in confidence in the Shariah compliant products on offer by the firm. According to the OECD principles of Corporate

Governance, overseeing succession planning is also one of the key responsibilities of the Board.

According to IFSB sub section17:

“Have a mix of members with different lengths of experience”

[IFSB, 2009]

a rationale for this is,

“...considering that the industry needs a consistent supply of highly competent and qualified members of the Shariah board, adequate time and opportunity must be given to grooming a new group of people who can acquire the relevant competence and experience.”

The IFSB clearly endorses a succession plan for the Shariah board.

A code of ethics existed for organisations, which was applicable to 40% of the employees, 21% to Directors, only in 10% of the companies, the code of ethics was applicable to all of the Shariah Board members, 10% to the executive officers, 5% of the respondents did not know who it was applicable to.

A code of conduct is a policy or procedure that is precisely targeted to diminish unethical behaviour. Lack of a code of conduct can contribute to white-collar crime and the existence of a code of conduct can help with the clear nature of the expectation of behaviour (Turner and Stephenson, 1993). Clear expectations of behaviour, company loyalty, and management integrity may strongly impact the occurrence of white-collar crime (Mitchell et al., 1996; Russell, 1995; Hooks et al., 1994).

Mitchell et al. (1996) found that the mere presence of a code of conduct has no impact. Key, Messina, and Turpen (1998–99) find that executives at firms with known or suspected occurrences of fraud identified poor internal controls and weak ethics policies as the two primary contributors.

Survey Question: Only 30% of the respondents indicated that the Shariah Board members were formally educated about the workings of the organisation prior to joining or during their time on the board, and 60% replied that they were not and 10% indicated that they did not know.

When asked whether 'The Accounting and Auditing Organization for Islamic Financial Institutions' (AOIFI) standards were adhered to by the organisation, an interesting range of responses was received, including:

- It is an educational institution and so does not apply
- Do not make actual investments. We advise and inform our clients.
- Optional and non-binding
- Voluntarily
- No, although Shariah standards are used as guidelines
- The bank follows the AAOIFI Shariah Standards, which have been regulated by State Bank, formally.
 - Other non-regulated standards are followed but informally. "Informally" means no regulatory requirements are there but Shari'ah Board members follow it in more than 99% cases.
 - In one 1% cases some domestic Fatwas are adopted due to difference in Fiqh opinions
- Partially depending on country of subsidiary
- Guidance only
- Yes, Audited Financial Statement issued in accordance with AAOIFI
- In UAE the general rule is to follow AAOIFI standards but to what extent they follow is unknown
- Both formal and informal standards are followed. Formal standards by the AAOIFI and informal by the Shariah board
- All Shariah standards, which have been regulated, are followed formally. Other non-regulated standards are also followed informally. The board members and not the state set these standards.

Of the respondents 45% answered yes, 35% No and the remaining included some of the responses above or statements to the same effect.

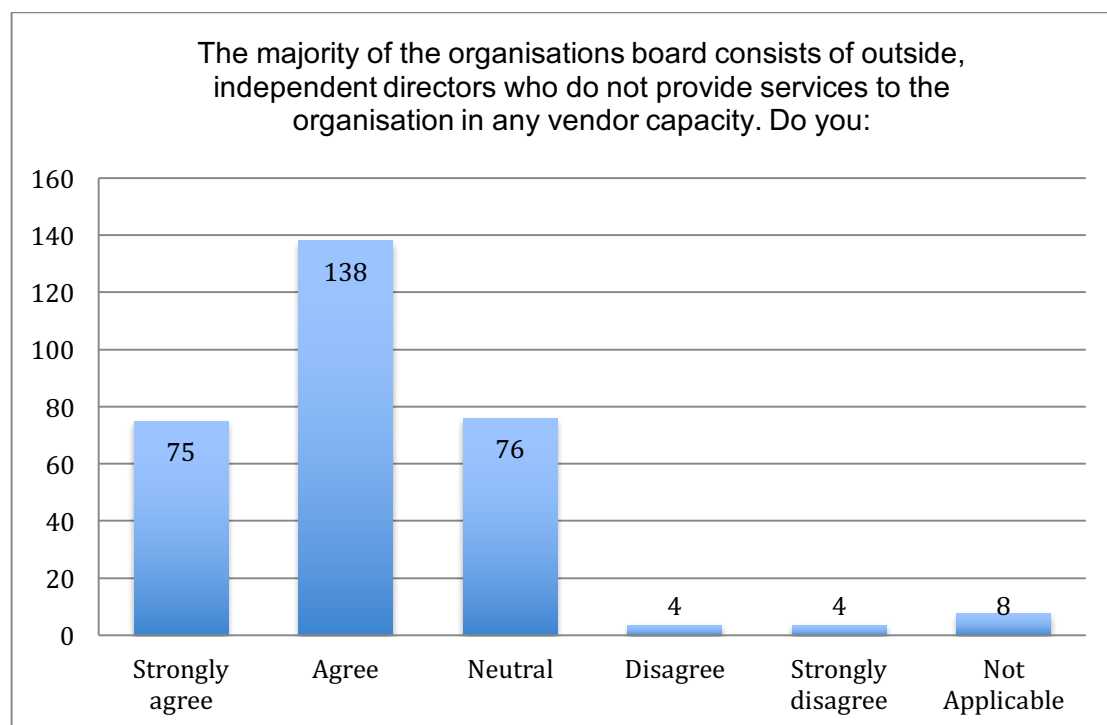
Countries where AAOIFI standards are either mandatory or recommended include:

- Bahrain
- Malaysia
- United Arab Emirates (UAE)
- Saudi Arabia
- Lebanon
- Syria
- Sudan
- Jordan

Before the implementation of AAOIFI standards many financial institutions in these countries were functioning under a “semi-regulated market” (Al Baluchi, 2006).

The specific research question posed, “Identify the problems that the organisation is facing with regards to corporate governance issues that are specifically related to the Shariah” is clearly highlighted by the responses to this question. The fact that the vast majority of the Shariah board are not formally educated about the workings of the organisation prior to joining or during their time on the board highlights a specific issue for IFI’s. The issue of credibility of the Shariah board may be raised, as they are issuing verdicts about areas where they have not really received any formal education. How is this possible? How is this credible? This approach is not the same as in conventional organisations.

Survey Question: The majority of the organisations board consists of outside, independent directors who do not provide services to the organisation in any vendor capacity. Do you:



The vast majority agreed that this should be the case. The agency model is widely accepted in the business community, as is seen by the widespread acceptance of normative guidelines emphasizing the need for independent directors to monitor the activities of the board (Bosch, 1995; NACD, 1996).

Economic theories are based on the belief that an independent board of directors will safeguard shareholders' interests and minimize opportunism on the part of management. Explicit in these formulations is the assumption that outside or independent directors (non-management directors) are more able to do this than insider directors. It seems that the respondents in the survey agree with this view from economic theories that the boards should consist of independent outside board of directors. The reality is that this is not the case in Islamic Financial Institutions (IFI's).

The empirical studies that have observed the impact of the insider-outsider ratio on

boards have discovered no reliable proof to suggest that increasing the percentage of outsiders on the board will improve performance. They suggest that pushing too far to remove inside and affiliated directors may harm firm performance by denying boards of the precious firm and industry specific knowledge they offer (Fama and Jensen, 1983; Baysinger and Hoskisson, 1990).

Some studies recognized a positive relationship between the percentage of outside directors and firm performance (Schellenger et al., 1989; Pearce and Zahra, 1992; Daily and Dalton, 1993), while other studies found no significant relationship between board composition and company performance (Mallette and Fowler, 1992; Daily and Johnson, 1997; Bhagat and Black, 1999; Hermalin and Weisbach, 1991; Klein, 1998; Dulewicz and Herbert (2004) for the UK).

Dalton, Daily, Ellstrand, and Johnson (1998) and Wagner, Stimpert, and Fubara (1998) conducted meta-analyses of the research on board composition and performance. Dalton et al.'s (1998) analysis of 54 studies found no evidence of a link between insider-outsider ratio and company financial performance, and showed that neither the size of the company nor the measures used for director type nor company performance affected the findings.

They also found some evidence of a U-shaped relationship between the insider-outsider ratio and performance; as boards with a very high or low percentage of insiders performed better than those with a more even mix of insiders and outsiders. Barnhart, Marr, and Rosenstein (1994) and Barnhart and Rosenstein (1998) found evidence of a converse curvilinear relationship between the percentage of independent directors as classified by Institutional Shareholder Services (ISS) and some performance measures. They reported that firms where boards have a clear majority of independent directors or very few independent directors had lower stock market performance.

According to IFSB principle 3.1, sub section 41:

“A Shariah board can only be deemed “independent” when none of its members has a blood or intimate relationship with the IIFS, its related

companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of independent judgement in the best interests of the IIFS by the Shariah board. In the case of Shariah advisory firms, it can only be deemed independent from the IIFS if they are not related parties, such as in terms of having common shareholders or common directors.

[IFSB, 2009]

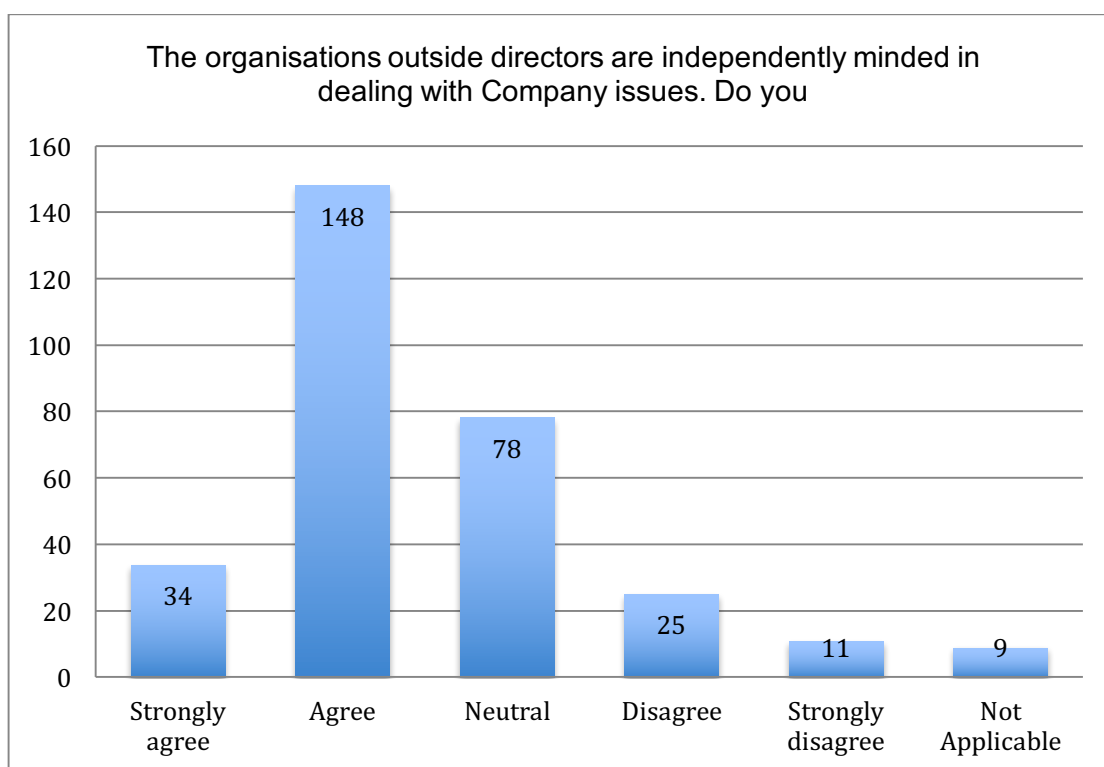
The author recommends that the boards should include an appropriate mixture of independent non-executive directors, such that no individual or small group can dominate the board's decision taking. The author would like to emphasise that International Corporate Governance Codes require that at least one third of the Board members should be Independent and a majority of the Board should consist of Non- Executive Directors.

The questions of:

- Islamic Financial Institutions need to comprehend the objectives, role and purpose of the Shariah
- Islamic Financial Institutions need to appreciate the importance of good corporate governance
- What does the Islamic system of life mean for corporate governance of financial institutions?
- How do Islamic principles apply to corporate governance?
- What regulations and guidelines does the Shariah provide to regulate corporations?

It is clear that Islam and the Shariah provides answers to all of the above questions, yet it is clear that the IFI's choose to either not follow them, ignore them or selectively follow them.

Survey Question: The organisations outside directors are independently minded in dealing with Company issues.



Most agree that outside company directors would be independently minded in dealing with company issues. As to the mechanism by which a board is likely to impact on corporate performance, agency theory advocates that a larger percentage of outside / independent directors recognising that these two terms are not identical and will be able to monitor any self-interested actions by managers. As a result of the monitoring there will be less opportunity for managers to pursue self-interest at the expense of owners and so shareholders will enjoy greater returns.

Students of corporate governance agree that the board has the following duties and responsibilities:

- I. Overseeing of management to include the selection, monitoring, evaluation, compensation, and replacement of the CEO
- II. The management of the board to include the selection and

replacement of board members

- III. Reviewing the firm's financial performance and approving the allocation of funds
- IV. Insuring compliance with the law and corporate social responsibility (e.g. Lorsch, 1989; Walsh and Seward, 1990; Jacobs, 1991)

Although most agree (182 out of 305), that outside directors would be independently minded in dealing with company issues, it is to be noted that the survey did not ask for the actual figure of outside / independent directors at each organisation.

Fama (1980, p. 294) claims that the board's 'most important role is to scrutinize the highest decision makers in the firm'. Mizruchi (1983, p. 433) advises that 'the ultimate center of control' in a publicly held firm is the board. Gilson and Kraakman (1991, p. 873) assert that 'in the corporate governance debate, all arguments ultimately converge on the role of the board of directors in general, and on the role of outside directors'.

Research on corporate boards and board reform efforts has been dominated by a concern for board independence and its effect on the scrutinising of the CEO. Boards of directors play many roles, however, they are mainly responsible for providing oversight, advice and monitoring of the CEO. This independence of the board is central for effective Corporate Governance. Dalton (1998) says that outsiders are assumed to be more attentive, as they are not reliant on the CEO, shareholders or their representatives. While overall board configuration does not show a clear link with performance, the presence of more independent directors might support more ethical behaviour and deeper oversight into board committees.

According to IFSB Principle 3.1, sub section 42:

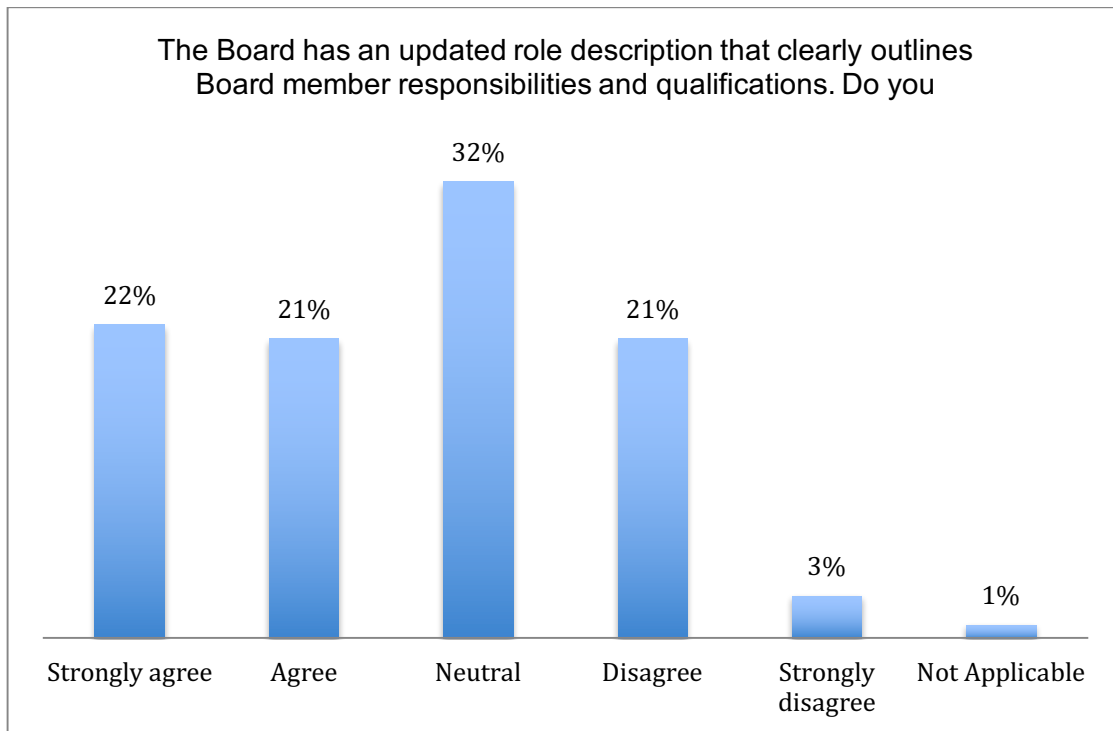
“Adapted from international best practices usually applicable to independent, non-executive members of the BOD, the following are examples of relationships that would deem a member of a Shariah board as

lacking independence from the IIFS he or she is serving, and thus must be avoided:

1. A member of the Shariah board being under full-time employment by the IIFS or any of its related companies for the current or during the last financial year
2. A member of the Shariah board who has an immediate family member such as spouse, children or siblings who are, or who were during the last financial year, employed by the IIFS or any of its related companies as a senior executive officer
3. A member of the Shariah board, or his or her immediate family member, accepting any compensation or financing from the IIFS or any of its subsidiaries other than compensation for service on the Shariah board
4. A member of the Shariah board, or his or her immediate family member, being a substantial shareholder of or a partner in (with a stake of 5% or more), or an executive officer of, or a director of any for-profit business organisation to which the IIFS or any of its subsidiaries made, or from which the IIFS or any of its subsidiaries received, significant payments in the current or immediate past financial year.“

[IFSB, 2009]

Survey Question: The Board has an updated role description that clearly outlines board member responsibilities and qualifications.



The need for firms to make clear the behaviour expected from board members is generally recognised. For example, the Australian Stock Exchange (ASX) Corporate Governance Council advises organisations to “clarify the standards of ethical behaviour required of company directors and key executives . . . and encourage the observance of those standards” (2003).

The OECD, the Higgs report in the UK, the New York Stock Exchange (NYSE) and the Council of Standards Australia, has also developed similar guidelines for Corporate Governance.

The Higgs report (2003), states that:

“The board should set the company’s values and standards and ensure that its obligations to its shareholders and others are understood and met”.

There is a recognised need for companies to provide information relating to

expected behaviour to all employees. The Investment and Financial Services Association Limited (IFSA) Guideline 17 (2003), commends the acceptance of a company code of ethics.

The NYSE Rule 10 states:

“Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers and employees . . .” (2003)

According to Islamic Principles, there is a need for clarity and transparency in all that an individual or an organisation does. The duties and responsibilities of a individual must be made clear in order for the individual to undertake his / her role truthfully and to the best of his / her ability. This necessitates that role descriptions are defined and outlined. The board member is the guardian of what is under his / her guardianship, according to the following saying of the prophet Muhammad peace and prayers of Allah be upon him):

“Every one of you is a shepherd and is responsible for his flock. The leader of people is a guardian and is responsible for his subjects. A man is the guardian of his family and he is responsible for them. A woman is the guardian of her husband’s home and his children and she is responsible for them. The servant of a man is a guardian of the property of his master and he is responsible for it. Surely, every one of you is a shepherd and responsible for his flock.”

[Sahih Bukhari 6719, Sahih Muslim 1829]

The board in its role as the ‘Shepherd’ or guardian needs to understand what comes under the role and is then held accountable for that, as Allah will ask the individual in the Day of Judgment about all of the covenants and promises that have been made in his / her life. Those promises may be made to Allah or made to people.

Allah says in the Quran,

“And fulfill (every) covenant. Verily! The covenant will be questioned about. ”

[Surat Al-Israa, Ayah 34]

According to IFSB principal 1.2 sub section 20

“In order for the Shariah board to have a precise chain of command and accountability towards the respective stakeholders of the IIFS, it has to be equipped with:

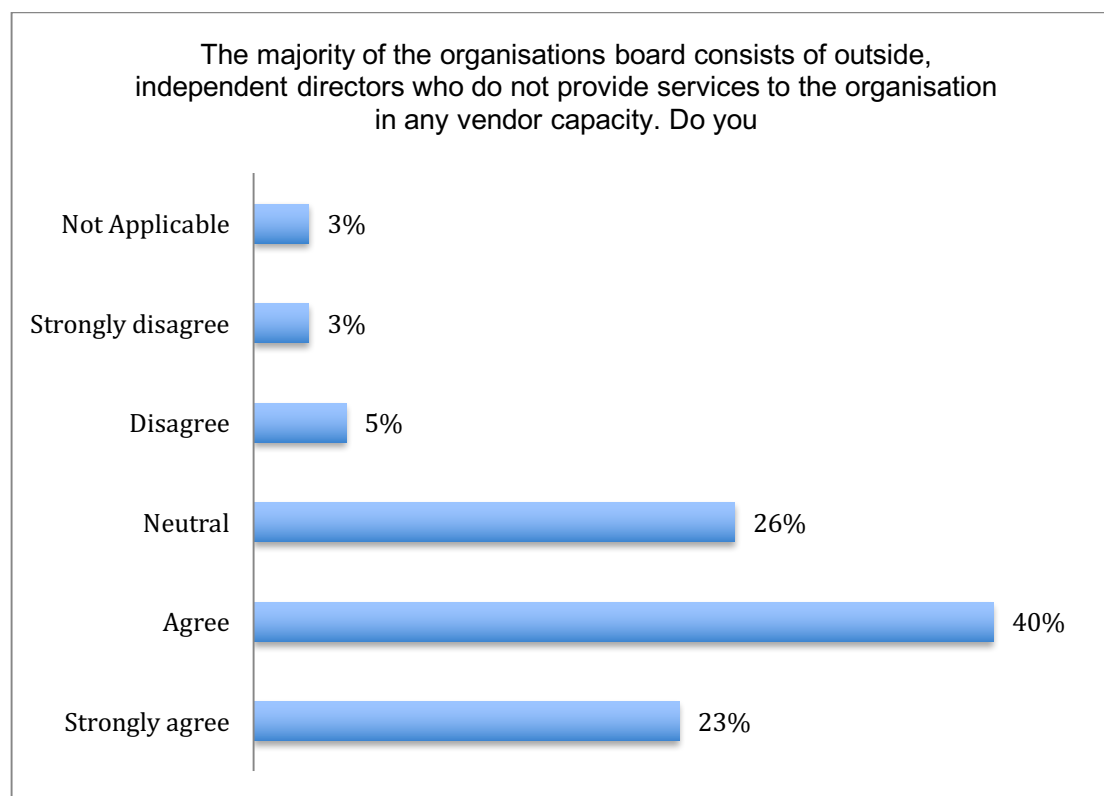
Well-organised operating procedures with regard to meetings, the recording of meetings, decision-making processes and to whom its decisions will be passed for effective implementation, including processes to review those decisions whenever necessary; and

[IFSB, 2009]

According to IFSB Appendix 1: Key Terms of Reference for the Shariah Board, this is clearly outlined with appointment, resignation and termination of service, along with the reporting structure, the power and authority of the Shariah board and the primary duties.

The author recommends that the members of the Board should be selected on merit, against objective criteria, and with due regard for the benefits of diversity, including gender diversity.

Survey Question: The majority of the organisations board consists of outside, independent directors who do not provide services to the organisation in any vendor capacity. Do you



Hameed (2008) raises the issue of the competence of Shariah Supervisory Board members when it comes to the performance of conducting Shariah audit. He argues that although the members of Shariah Supervisory Board are well qualified in the task of issuing fatwas about the permissibility or otherwise of any financial product, they cannot stand as qualified auditors because they do not have the necessary qualification and training. Besides, their dual role of advising at the product development stage and auditing at the later stage creates ‘ self-review threat’ as per the international Federation of Accountants (IFAC’s) code of ethics.

The respondents agree that the board should have independent directors who do not provide services to the organisation in any vendor capacity. Unfortunately, we do not have empirical data to show whether this is the case or not. An independent director is asked to provide his / her professional expertise and is duly compensated for this professional expertise. Should the director’s compensation

be tied to the success of the company in the capacity as an external vendor to the company also, and then it would present an ethical problem. Setting clear boundaries and abiding by good ethical practices best address the potential for conflict of interest.

Are Islamic principles clear on safeguarding the rights and duties that an individual holds towards another and towards his / her work and business responsibilities. The Shariah clearly provides guidance on conflict of interest, as do IFSB principles.

The following research questions posed, clearly show that there are issues.

- What does the Islamic system of life mean for corporate governance of financial institutions?

The Islamic way of life caters for conflicts of interest, but it is clear that left to their own devices, people will choose to ignore them.

- How do Islamic principles apply to corporate governance?

Principles of conflict of interest, confidentiality and transparency in Islamic principles are clearly being selectively applied here.

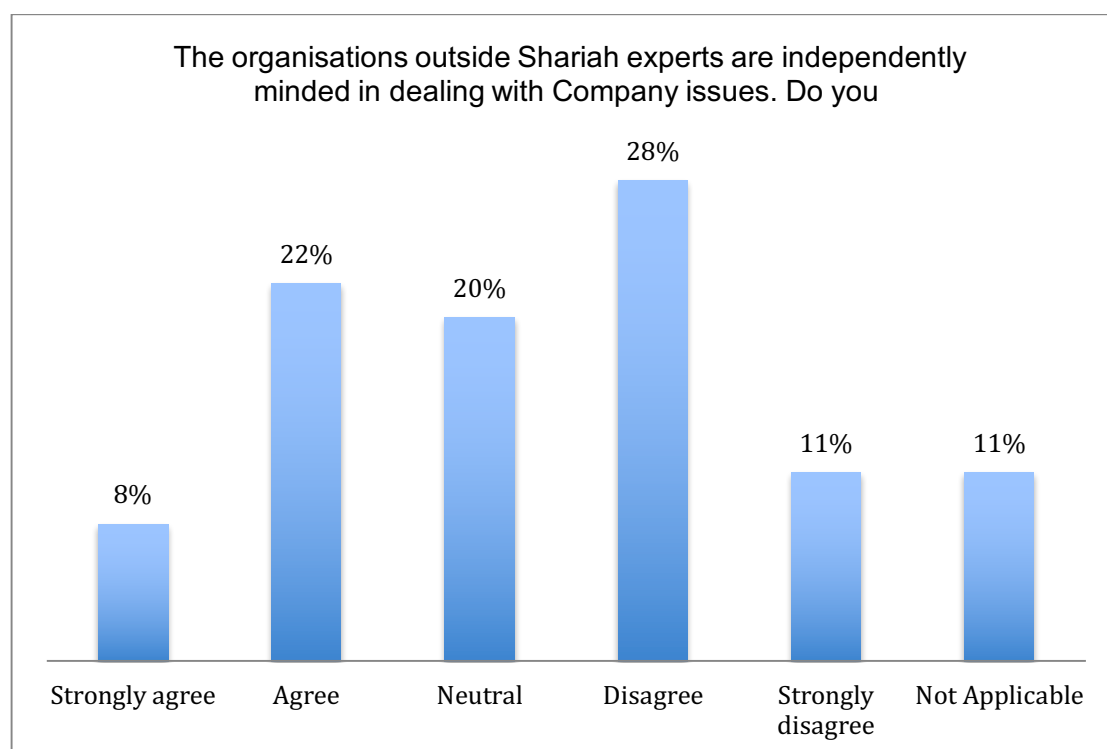
- What regulations and guidelines does the Shariah provide to regulate corporations?

Regulations of IFSB as a form of Shariah guidance are comprehensive

- How does the Islamic Corporate governance approach compare with the conventional approach to corporate governance?

The difference is in the application of the approaches to corporate governance. The problems facing conventional and IFI's are the same, the means to solve with them is different.

Survey Question: The organisations outside Shariah experts are independently minded in dealing with Company issues. Do you



22% of the respondents agree that the Shariah experts independently minded in dealing with company issues, whereas 28% do not argue that this the case, with a further 20% deciding to stay neutral and 11% strongly disagree. This makes 39% of the respondents disagreeing with the fact that the Shariah experts being independently minded.

Allah has divulged the concept of transparency in the following verse:

“O you who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties...”

[Surah Al-Baqarah Ayah 282]

This verse states that every transaction must be written to avoid injustice, and to preserve the terms and timing of these transactions, and the memory of witnesses, as mentioned at the end of the Ayah.

According to IFSB (2009) principles, no individual member of a Shariah board should be 'connected' with the company or serve another function within the company. Each member should be capable of exercising independent judgement. The management of the IFI should ensure that all relevant information is supplied to the Shariah board promptly and in such a manner that enables the board to discharge its duties properly. This will involve allowing the Shariah board independent access to senior management and providing for any further enquiries that may be made.

IFSB Principle 3.3, sub section 41 clearly states:

"A Shariah board can only be deemed "independent" when none of its members has a blood or intimate relationship with the IIFS, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of independent judgement in the best interests of the IIFS by the Shariah board. In the case of Shariah advisory firms, it can only be deemed independent from the IIFS if they are not related parties, such as in terms of having common shareholders or common directors."

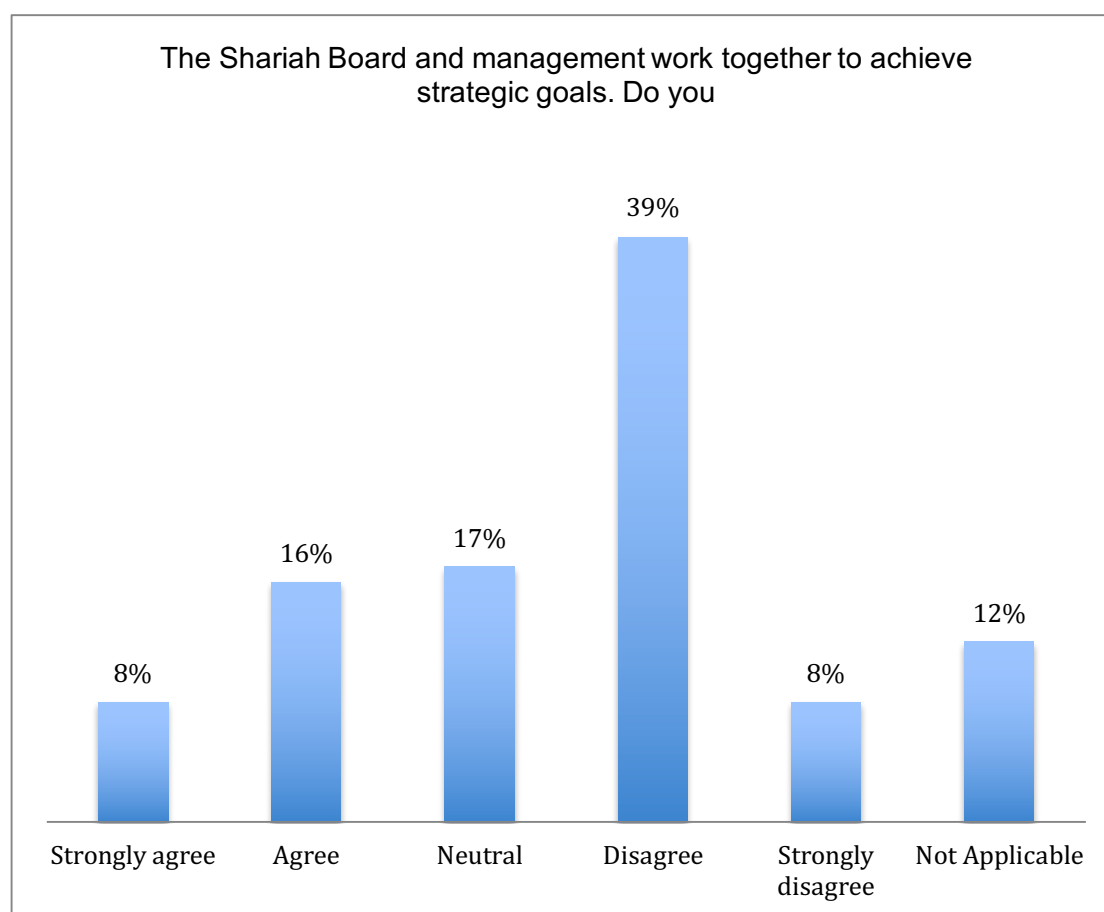
Sub section 44 states,

"In addition, wherever a conflict of interest is unavoidable, the member of the Shariah board or Shariah advisory firm should declare it in writing to the IIFS. They must similarly report any such conflict in regard to members of their family, business associates or companies in which they have an interest. Where there is such a conflict of interest, or a duty to another party, then they should abstain from participating in the relevant decision or action on behalf of the IIFS. Where a notification is made of a conflict, it should be recorded and retained by a designated officer. "

[IFSB, 2009]

The approach to this question and the previous one is the same.

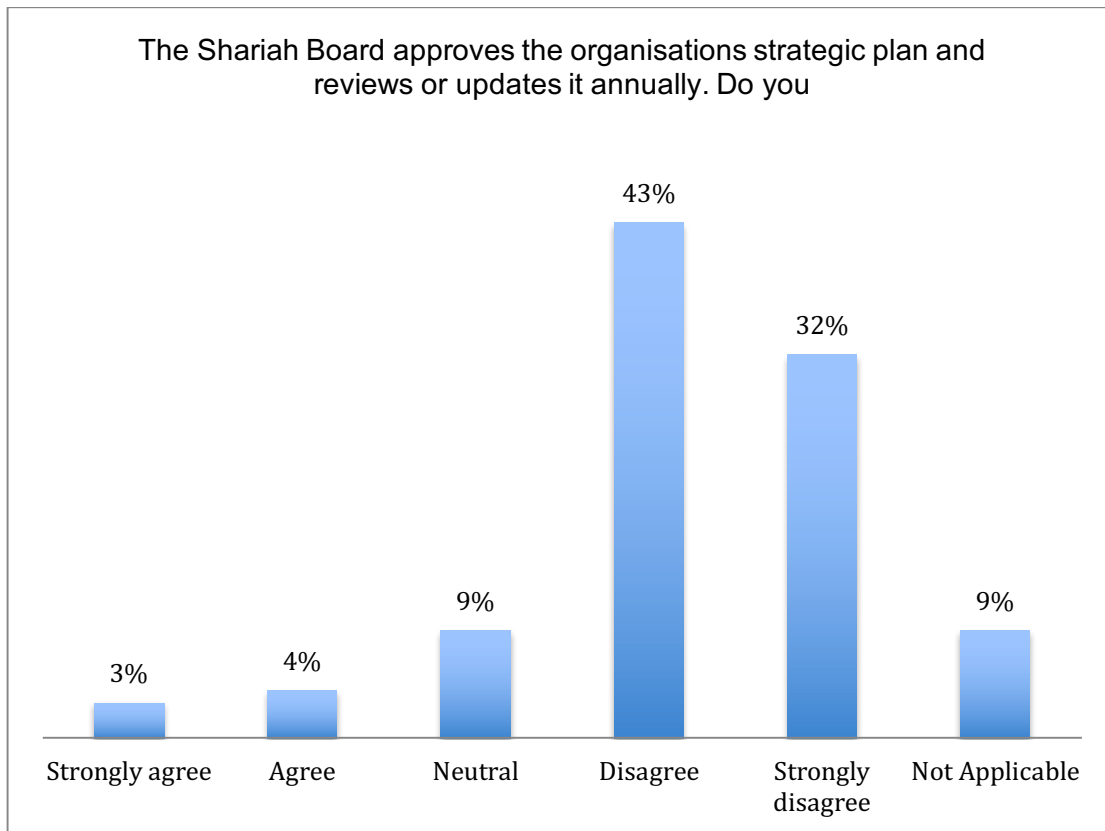
Survey Question: The Shariah Board and management work together to achieve strategic goals. Do you



There does not seem to be any day to day cooperation between the Shariah boards and the management of most of the companies, which indicates that there are no interferences from the Shariah board on the day to day operations. The flip side of this is that the Shariah board have no direct oversight on how the management are actually implementing the Shariah compliant products. This has been a major criticism of Islamic finance products, where the people implementing the Shariah compliant products do not understand the product and in fact ignore the principles that make the product Islamic. The negative opinions and harmful observations about the industry have resulted in Islamic financial products being viewed very sceptically. Islamic financial industry has been denounced as 'deception' and 'charade' (Saleem 2006a and 2006b). Seniawski (2001) and Holden (2007) identify the current practice in Islamic financial industry as 'legal hypocrisy'. ElGamal (2007 and 2008) claims that Islamic financial institutions are rent-seeking Shariah arbitrageurs using tricks to avoid prohibitions of Shariah law.

The fact that the Shariah board and management do not work together in the majority of the companies in the survey, 47% disagree and only 24% agree that they do; this could be a blessing for the companies. As there are a limited number of Shariah scholars on the boards, as shown by the earlier breakdown, then working together with management will possibly lead to a huge conflict of interest, as the Shariah board will have detailed working knowledge of the companies. Seen, as there are so many boards, it would be increasingly difficult to keep this knowledge from being inadvertently shared between companies and boards. This could lead to the products of the numerous companies who have the same Shariah scholars to have similar products, which would hinder innovation.

Survey Question: The Shariah Board approves the organisations strategic plan and reviews or updates it annually. Do you



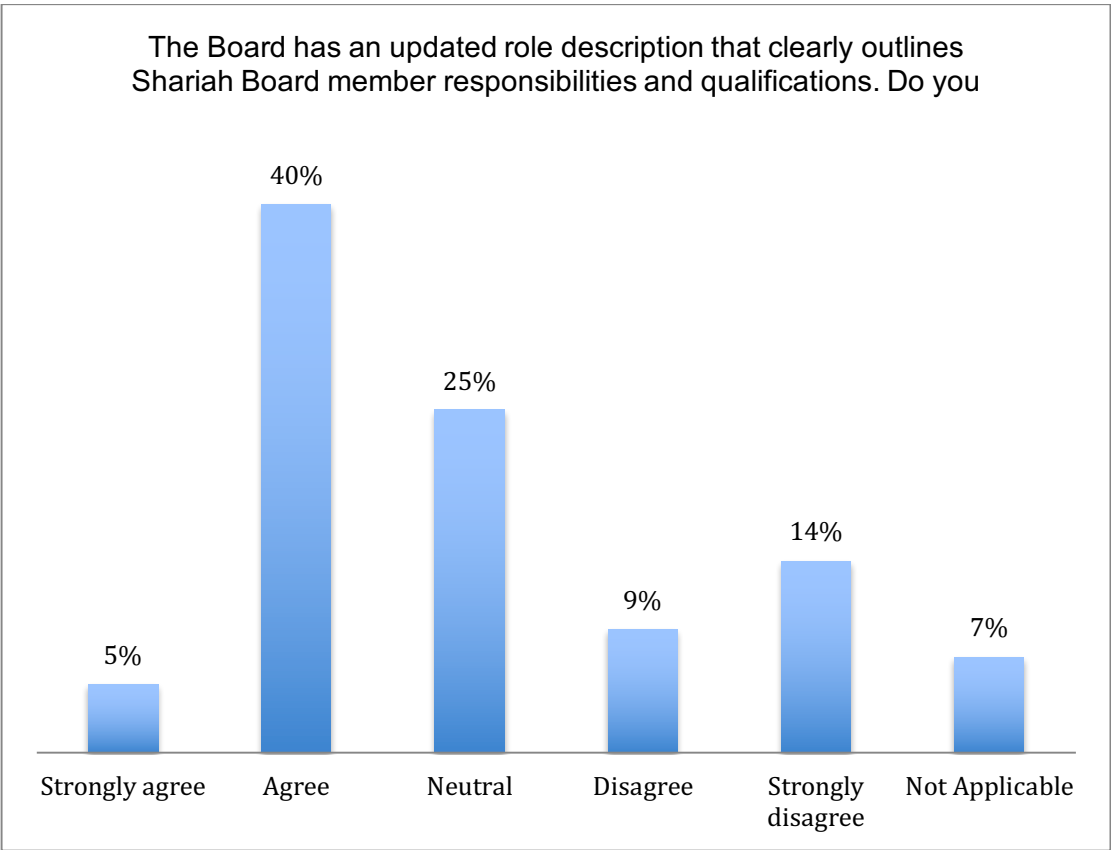
The role of the Shariah boards involves, issuing fatawa on products, Shariah audit to ensure compliance, calculating zakat, dispose of non-Shariah compliant income, provide advice on the distribution of income to the stakeholders, as well as providing guidance on its wider social role within society.

With these widespread roles of the Shariah boards, it can be argued that the role stretches to having input into the strategic plan of the organisation, in as much as it affects the Shariah compliance of the organisation as a whole, and with input on the mission of the organisation.

This begs the question, should boards restrict their activities to simply being aware of their organization's strategy or should they be more actively engaged in terms of determining, evaluating, influencing and eventually approving the strategy?

The responses from the survey indicate that 75% disagree (or strongly disagree) that the Shariah board has any involvement in the strategic plans of the corporation, whether that is in reviewing or approving it and only 7% actually have involvement.

Survey Question: The Board has an updated role description that clearly outlines Shariah Board member responsibilities and qualifications. Do you



The responses to this should be unequivocal ‘yes, they’, however only 45% say they do and a further 23% disagreeing, with 25% staying ‘neutral’, which indicates that they do not know if this is the case. Good practice according to the IFSB principles clearly state that this must be the case, refer to Appendix 1, Key Terms of Reference for the Shariah Board (IFSB, 2009).

IFSB Principle 2.1,

“The IIFS shall ensure that any person mandated with overseeing the

Shariah Governance System fulfills acceptable fit and proper criteria.”

Subsections 29 and 30 state,

- I. The IIFS should ensure that members of the Shariah board demonstrate the competence and ability to understand the technical requirements of the business, the inherent risks therein, and the management processes required to conduct its operations effectively, with due regard to the interests of all stakeholders. In assessing the competence and capability of a person, all relevant factors should be considered, including, but not limited to:
 - Whether the person has demonstrated, through qualifications and experience, the capacity to successfully undertake the responsibilities of the position
 - Whether the person is physically, mentally and emotionally fit to perform his or her duties
 - Whether the person has ever been disciplined by a professional, trade or regulatory body, dismissed or requested to resign from any position or office for negligence, incompetence, fraud or mismanagement; and
 - Whether the person has a sound knowledge of the business and the responsibilities of the position.
- It follows that members of the Shariah board and officers of the ISCU and ISRU should at least possess the appropriate knowledge and skills in order for them to adequately execute their duties and responsibilities. IIFS should be diligent by carrying out background checks on candidates to be appointed to the respective positions. A list of minimum competencies for members of the Shariah board is set out in Appendix 4”

[IFSB, 2009]

The list of competencies as identified by the IFSB include,

“...bachelor’s degree / ijazah from a recognised university in the sciences of

Shariah, including Islamic transaction/commercial law (Fiqh al- Muamalaat), and be able to demonstrate an adequate understanding of finance in general and Islamic finance in particular”

[Appendix 4, IFSB 2009]

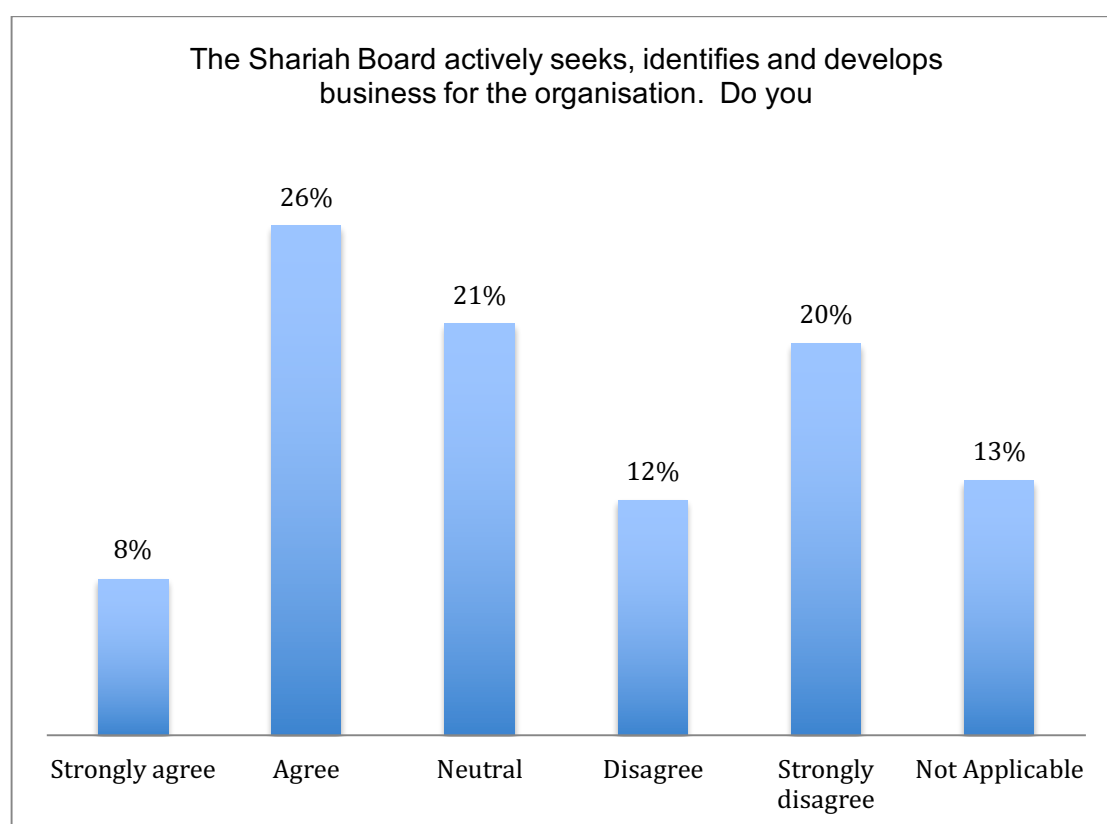
There are other recommendations in terms of experience, which the author believes are not unreasonable. They would be expected from a professional in another field of work, if they wished to practice their profession and so should be the case here.

The author would be intrigued to discover how many of these Shariah scholars actually have met the criteria of the IFSB. If they employed in the capacity of Shariah scholars without these qualifications and experience, then how is this possible?

How can an Islamic financial institution employ people who are not suitably qualified?

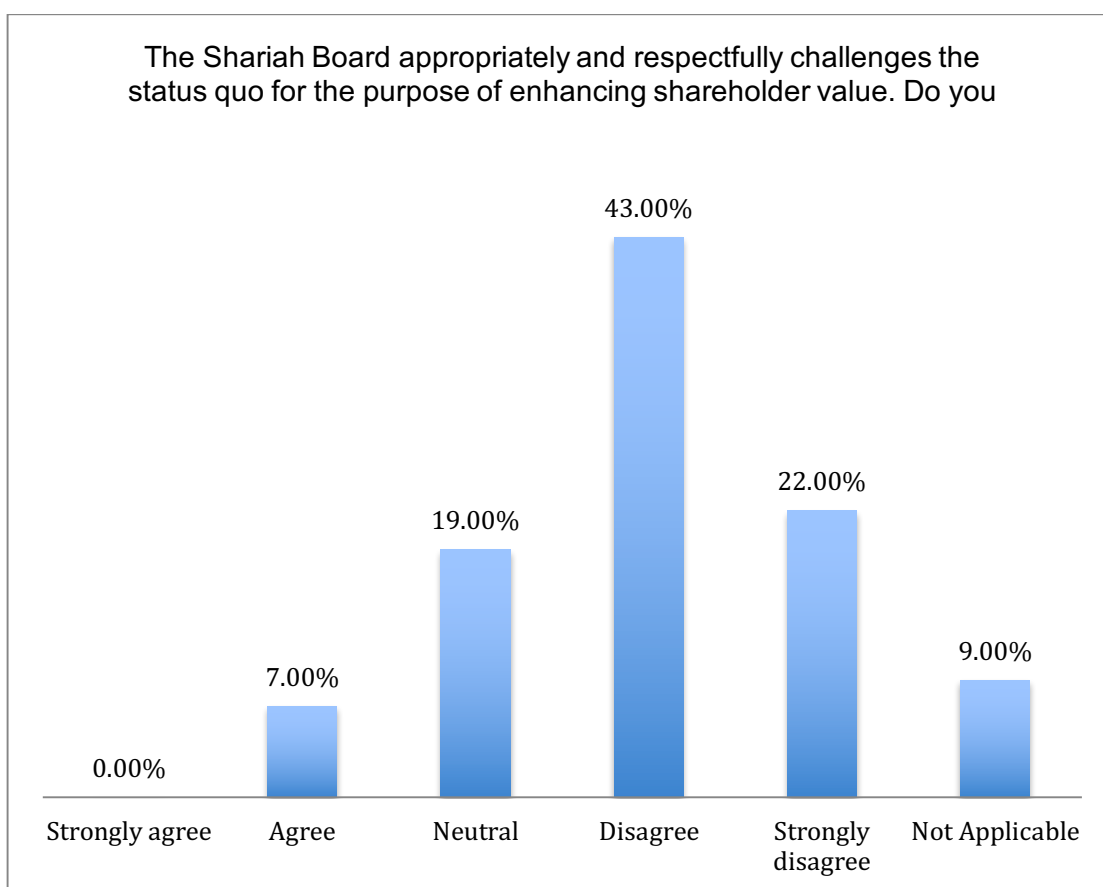
And how can Shariah scholars offer themselves as Shariah scholars and take on such roles, when they are aware that they are not suitably qualified? The issue of Amanah (trust) from both parties comes in question.

Survey Question: The Shariah Board actively seeks, identifies and develops business for the organisation. Do you



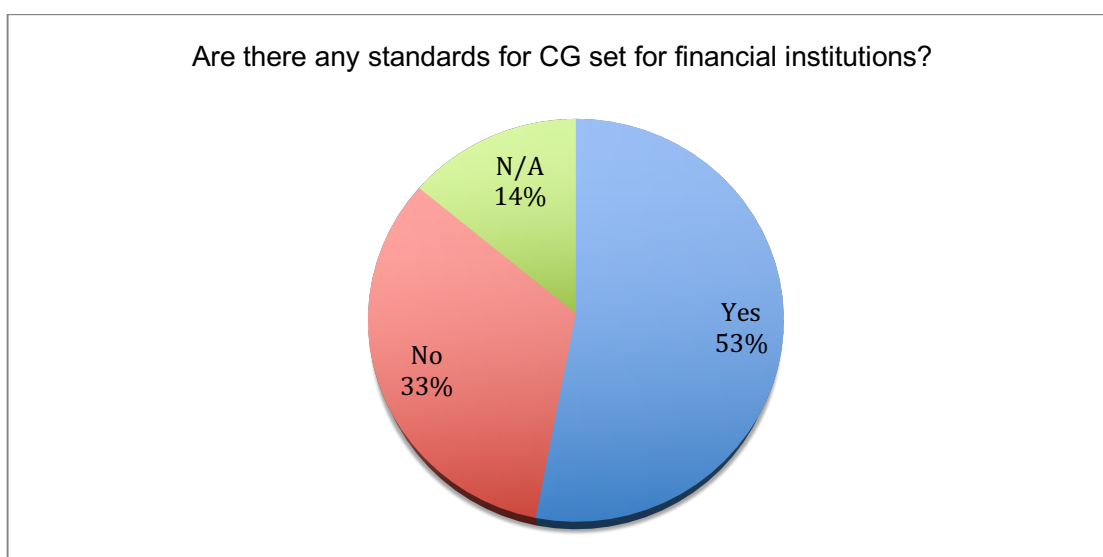
The Shariah boards compensation is tied to the success of the company, and then it would present an ethical problem. Professional ethics prevent should Shariah board members from holding shares in a company for which they provide their opinion. If the Shariah board stands to gain a higher financial gain as a result of soliciting business for the company, then a potential conflict of interest may arise, whereby possibly the Shariah board has to provide an opinion on a matter which is borderline halal or haram. The Shariah board may favour the transaction due to the future potential financial gain for them, to avoid this situation, Islamic principles would dictate that this potential conflict be avoided at all costs.

Survey Question: The Shariah Board appropriately and respectfully challenges the status quo for the purpose of enhancing shareholder value. Do you



Most respondents do not agree that the Shariah board respectfully challenges the status quo for enhancing shareholder value, a total of 65% of the respondents disagreed. This maybe because the Shariah board does not wish to have a conflict of interest or just does not have the mandate to be involved in such activity with the firm.

Survey Question: Are there any standards for corporate governance set for financial institutions?



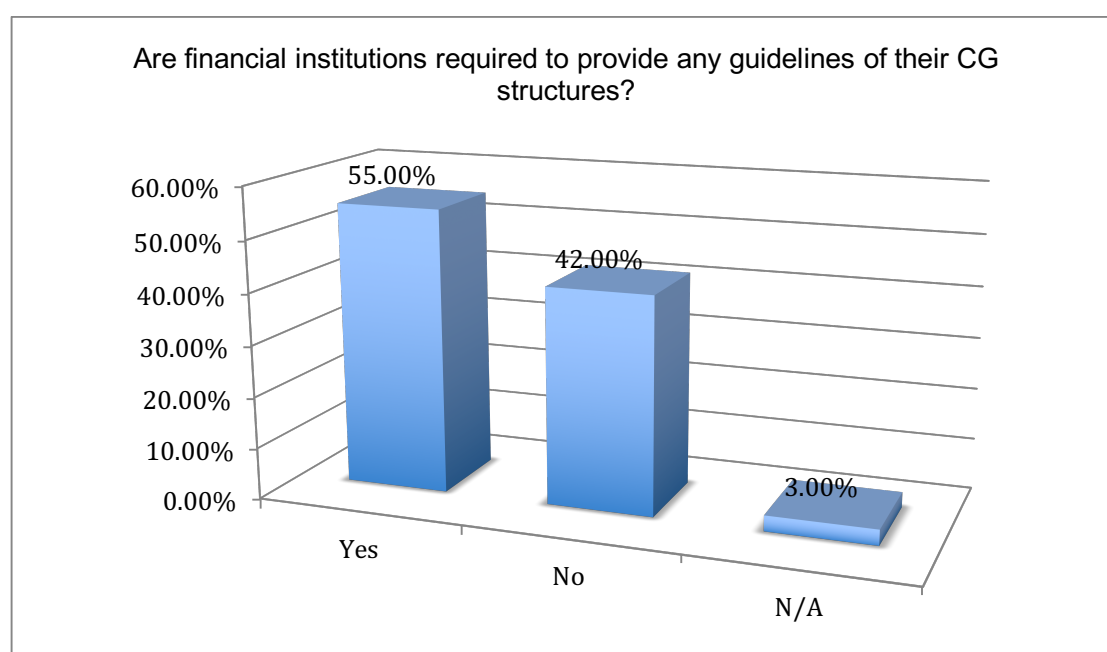
These could be IFSB, or those from the jurisdiction of the organisations location. A yes of 53% is still very low, with 33% saying No. This means that either the organisation has no standard to which it adheres or they operate whereby they can circumvent corporate governance standards, and rely on internal standards only.

The Islamic finance institutions are encouraged to use the international benchmark for their corporate governance code particularly the AAOIFI Governance Standards and the IFSB Guidelines. According to OECD Principles of Corporate Governance, it is the responsibility of the Board to develop a corporate governance framework that ensures strategic guidance, effective monitoring of management and the board's accountability to the company and its shareholders. The corporate governance code for Islamic Financial Institutions is strongly recommended to be made mandatory by law. The regulatory authorities should issue standards for compliance with all laws and regulations and responsibility pertaining to corporate governance.

For those 33% who said No, then applying the IFSB or OECD standards seem to be a logical thing to do.

It is clear that there are guidelines available to IFI's which by their very nature are Shariah based and guided, as well as the duties that are incumbent upon a Muslim to undertake and follow. These being based on the Islamic principles of honesty and to giving the rights to those who rights are due towards; which in this case is towards your work and to those in authority over you.

Survey Question: Are financial institutions required to provide any guidelines of their corporate governance structures?



A resounding 42% of organisations did not have to provide guidelines for their corporate governance structures. These 42% of respondents who do not have guidance on corporate governance structures should, it would seem logical, adopt the IFSB ones.

This clearly indicates that, these organisations DO NOT:

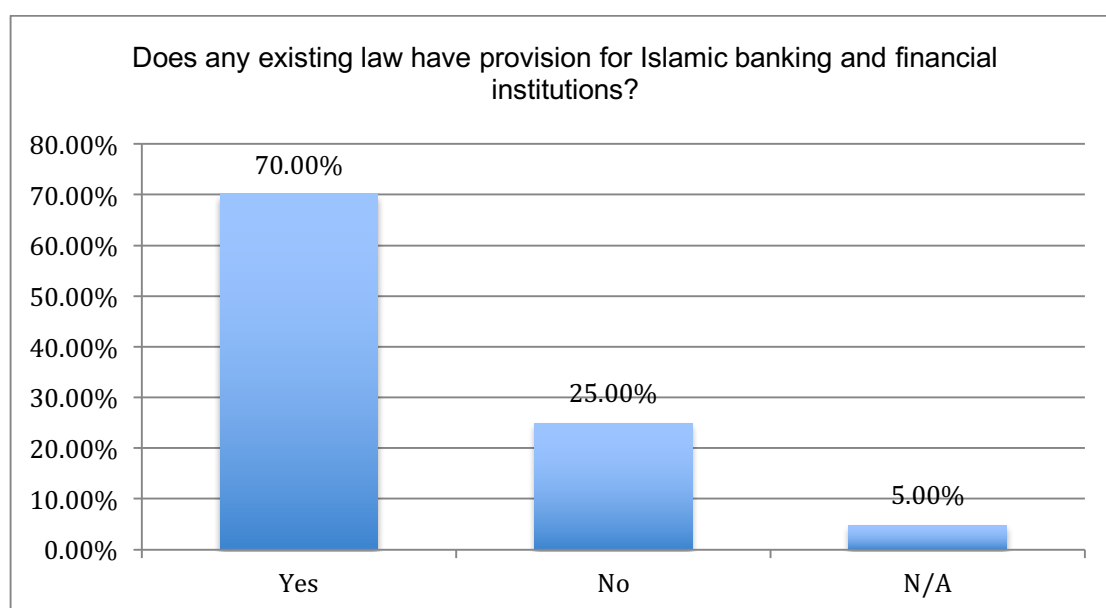
- Comprehend the objectives, role and purpose of the Shariah
- appreciate the importance of good corporate governance

and although,

The approach to Islamic Corporate governance is similar to the conventional approach to corporate governance, the implementations by IFI's is not.

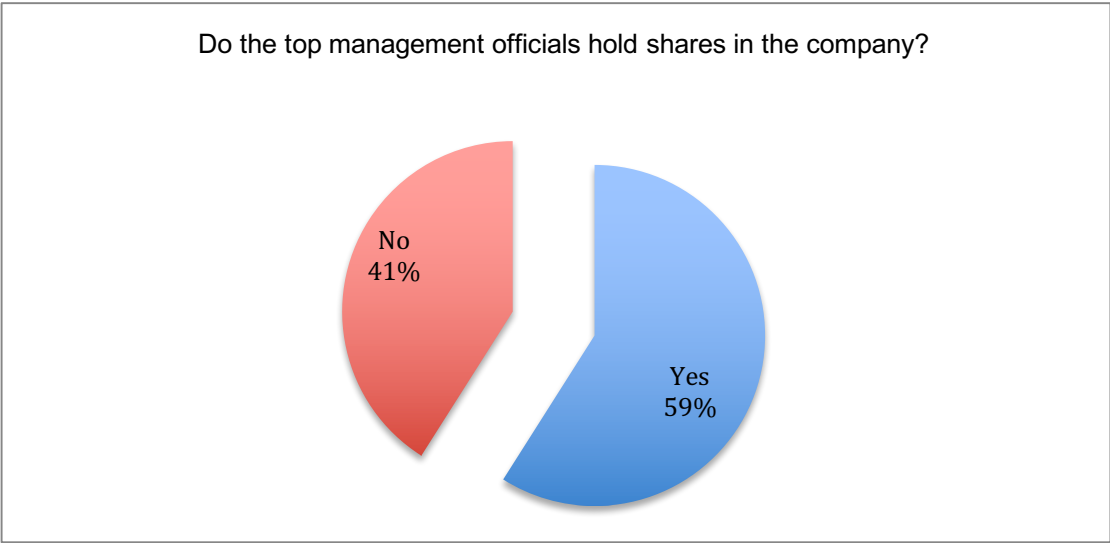
The convergence is to the approach and not in its implementation, and it seems there is a divergence in implementation. There clearly needs to be a similar implementation of Shariah corporate governance by IFI's as they have on their conventional approaches. It seems that the IFI's will follow the approaches to conventional corporate governance when they are bound by regulations, however, the same regulation for Shariah corporate governance is not followed with the same enthusiasm.

Survey Question: Does any existing law have provision for Islamic banking and financial institutions?



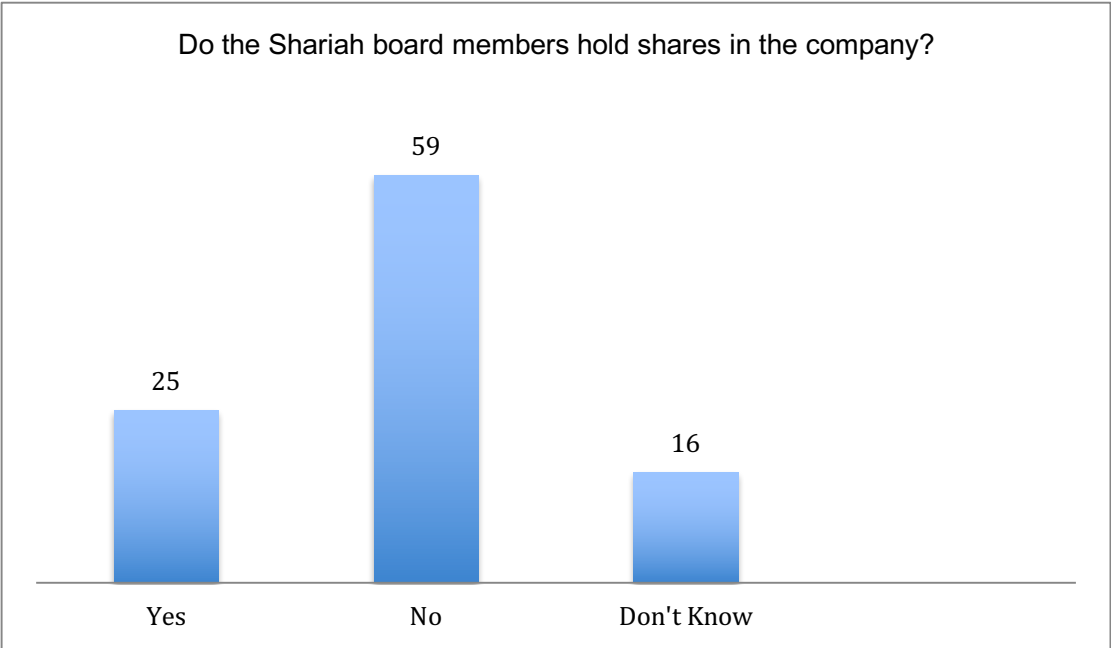
The fact that 25% of the respondents were operating where there was no existing law for Islamic banking and financial institutions is quite concerning. However, it could simply be that other laws governing banking and financial institutions apply to these organisations.

Survey Question: Do the top management officials hold shares in the company?



In 59% of the respondent’s top management did hold shares in the organisation, which can be a good thing, as they are more than just employees of the organisation and as such have a stake, which is greater than simply being an employee. The OECD Principles also require the disclosure of ownership of shares.

Survey Question: Do the Shariah board members hold shares in the company?



The fact that 25% of the respondents said that the Shariah board members held

shares in the organisation is quite alarming due to the conflict of interest issue and the clear guidelines of the IFSB. This is not good practice and it must not take place to improve confidence in Islamic financial institutions.

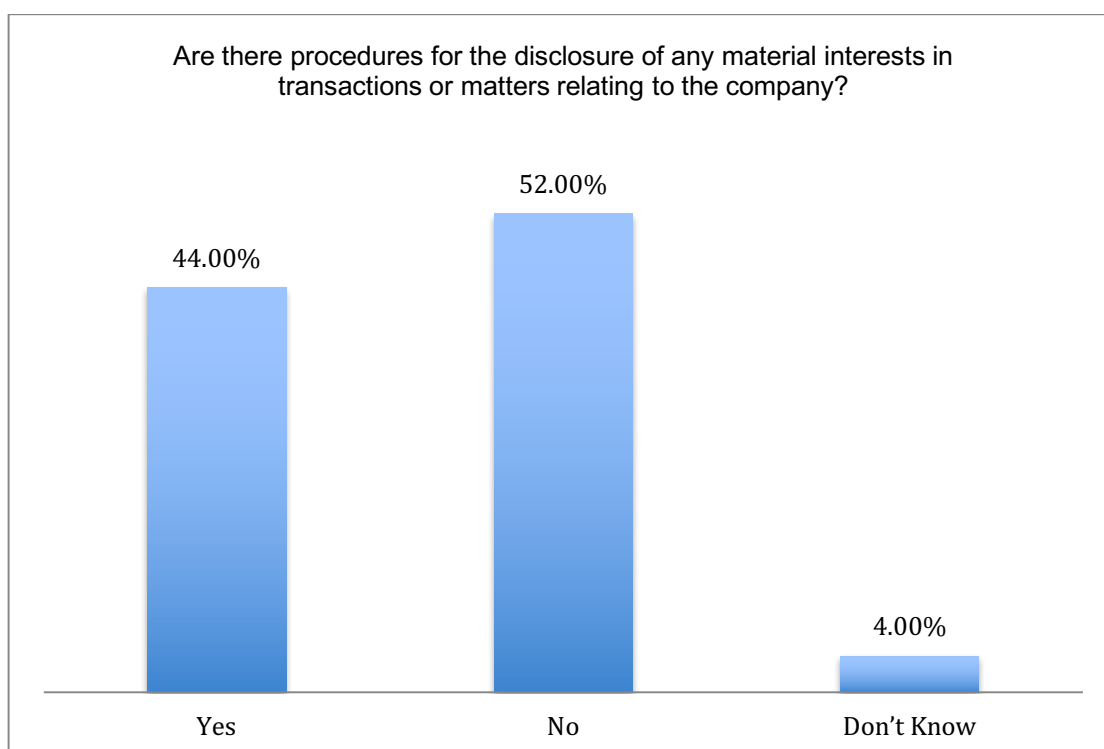
According to IFSB principal 3.1 sub section 42

“...the following are examples of relationships that would deem a member of a Shariah board as lacking independence from the IIFS he or she is serving, and thus must be avoided:

(iv) A member of the Shariah board, or his or her immediate family member, being a substantial shareholder of or a partner in (with a stake of 5% or more), or an executive officer of, or a director of any for-profit business organisation to which the IIFS or any of its subsidiaries made, or from which the IIFS or any of its subsidiaries received, significant payments in the current or immediate past financial year ”

[Guiding Principles On Shariah Governance Systems For
Institutions Offering Islamic Financial Services, Dec 2009]

Survey Question: Are there procedures for the disclosure of any material interests in transactions or matters relating to the company?



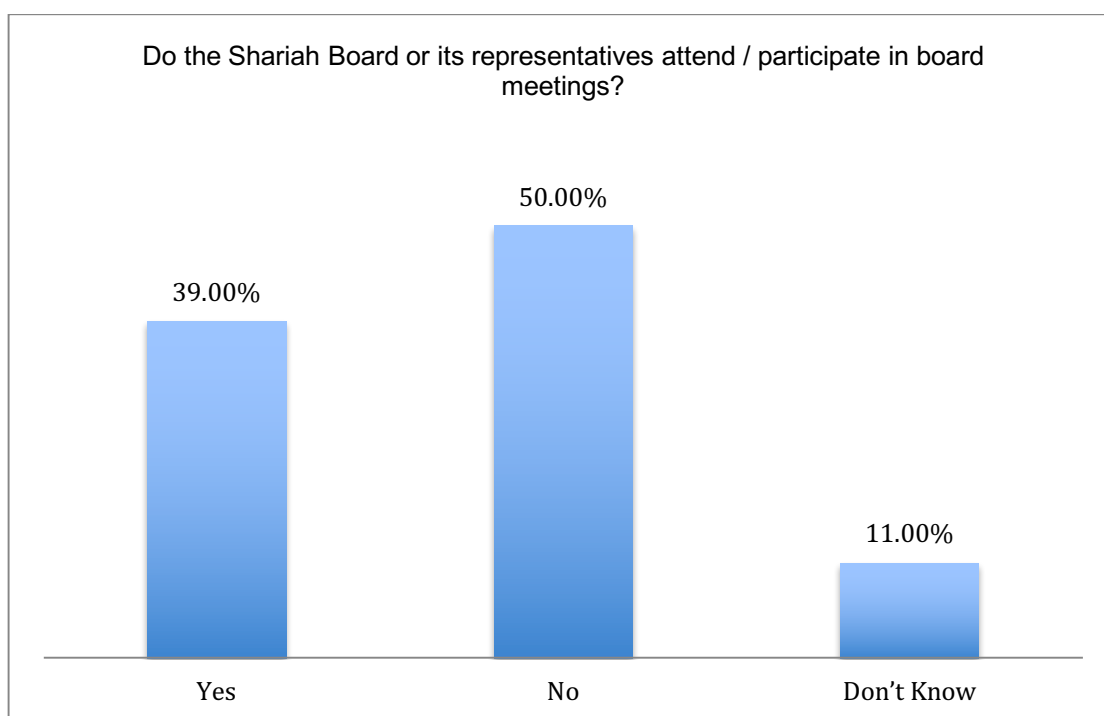
This is quite an alarming find, where more than 52% of the responded by saying that they were no procedures for disclosure of material interest, which is a clear route to a major conflict of interest and possibly leading to dishonesty. The principles of the IFSB are clear concerning such activities.

According to OECD Principles of Governance, Section V. Disclosure and transparency

“The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. “

[G20/OECD Principles of Corporate Governance, September 2015]

Survey Question: Do the Shariah Board or its representatives attend / participate in board meetings?



50% do not attend, whereas 39% do attend. The Shariah board members should not be privy to what happens at board meetings, they should only be concerned with the Islamic legality of the products. For example by attending the meeting, it might emerge that the company is going through some difficult times and in order to survive requires the new products being developed to be Shariah approved. They may lead to the Shariah board member being lenient on the Islamic legality of the product in order to help out the company. This can arise from both the Shariah board and the company side, where the company may exert undue behind the scenes pressure and the Shariah board compromising on the Shariah compliancy of the product under the circumstances.

The fact that the Shariah board attends 39% of the board meetings raises a huge question on transparency, confidentiality and conflict of interest. When so many Shariah scholars are present on multiple boards, then they can carry information, albeit inadvertently, to other companies. For example, when you are on 37 boards, keeping track of what information is from a particular board in your head can be

very difficult. Although, they will keep records on paper, what is in the mind of the individual can become muddled up. And when you exceed 50+ boards, then the author believes the integrity of such information is hard to maintain.

A Muslim avoids circumstances where such a conflict may occur, and the author believes the saying of the Prophet (PBUH),

“He who guards against doubtful things keeps his religion and honour blameless”

[Al-Bukhari & Muslim]

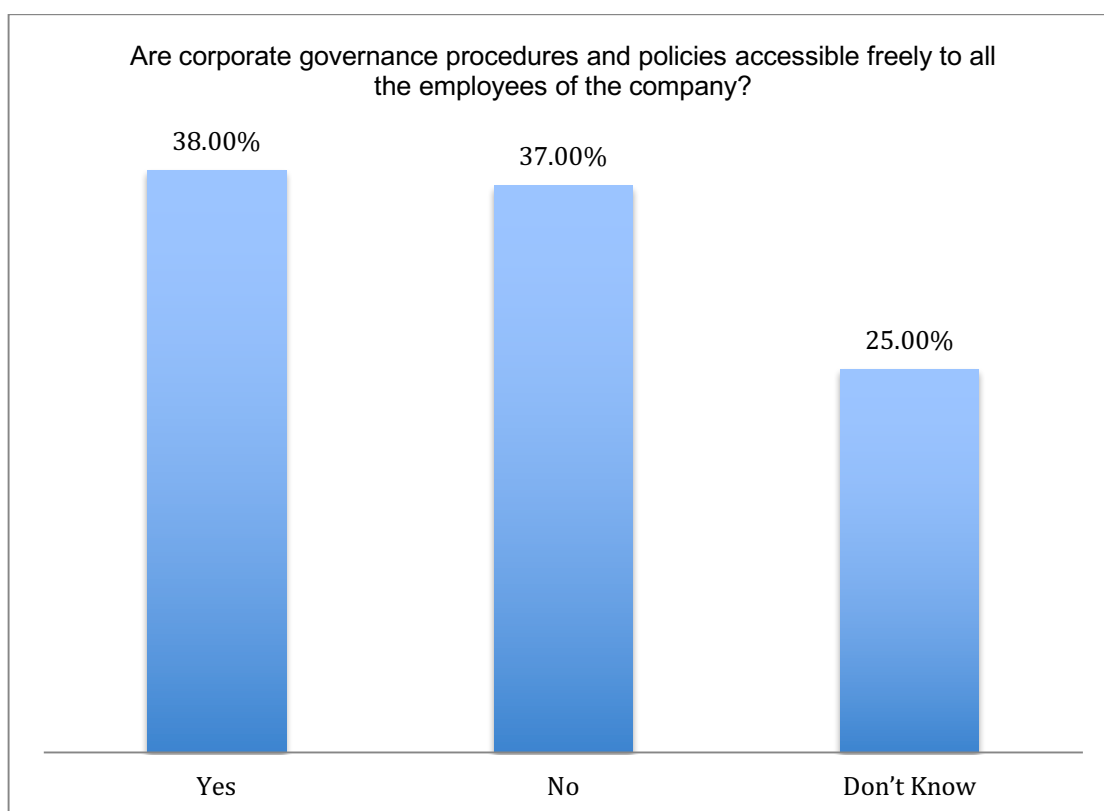
and the hadith,

“Leave that about which you are in doubt for that about which you are in no doubt”

[Al-Tirmidhi and al-Nasai]

That a person should not graze on the boundary / border, as surely the chance of transgressing the boundary / border becomes easier.

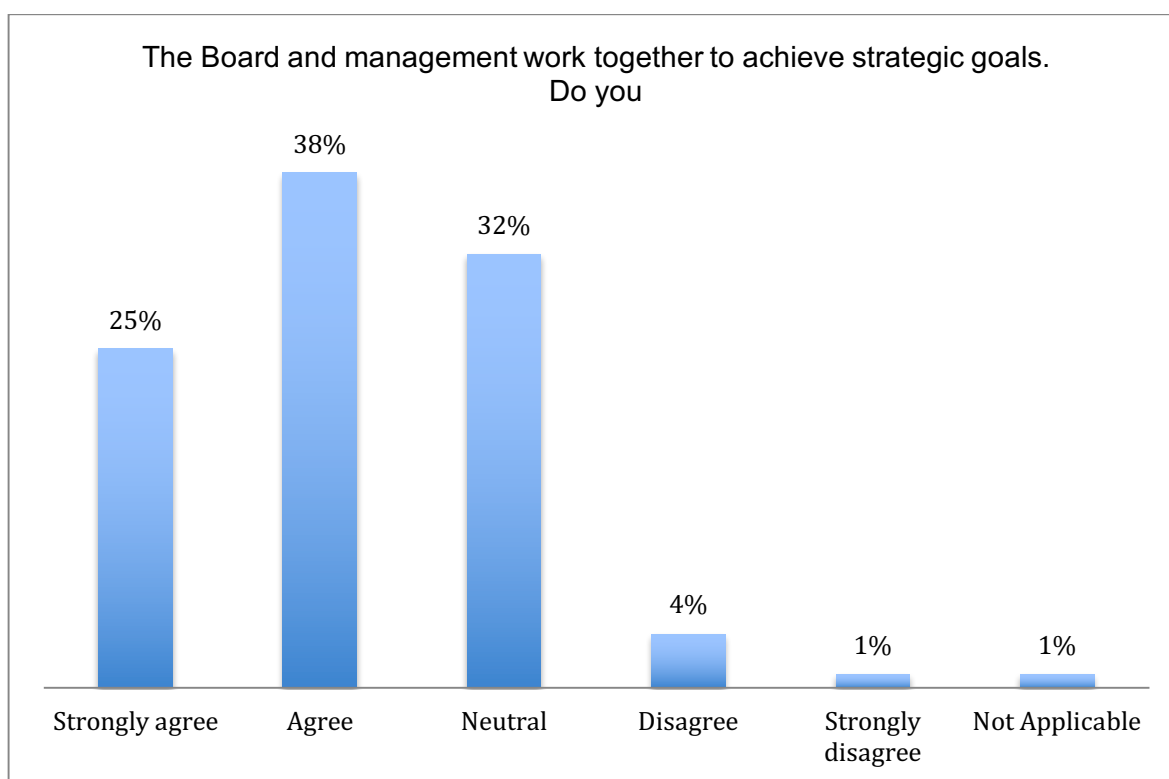
Survey Question: Are corporate governance procedures and policies accessible freely to all the employees of the company?



Firms have in place many policies to reduce or discourage fraud ineffective policies can contribute to the incidence of white-collar crime (Turner and Stephenson, 1993; Russell, 1995; Hooks et al., 1994). Bell et al. (1998) find that where management frequently overrides controls and does not segregate duties, audit fraud is more prevalent. Indeed, 'lax management attitudes, particularly toward internal controls, have frequently been linked to fraud and its detection' (Holmes et al., 2002: 85).

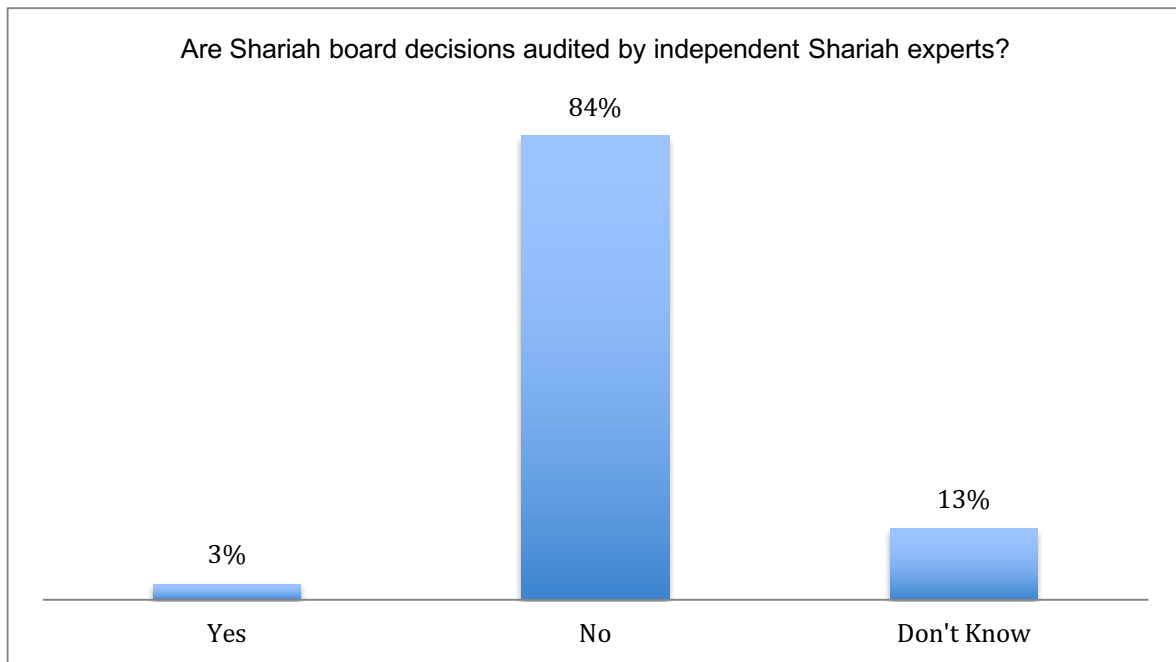
Good practice should be that all corporate governance policies should be easily accessible to all employees of the firm, as they apply to all of them. The employees and employers should be fully aware of the policies of the organisation.

Survey Question: The Board and management work together to achieve strategic goals. Do you



The fact that 63% of the respondents agreed, shows good practice, with only 5% disagreeing. This compares favourably with the conventional approach to corporate governance and shows a convergence in implementation. It also indicates IFI's comprehend the objectives, role and purpose of the Shariah and appreciate the importance of good corporate governance.

Question: Are Shariah board decisions audited by independent Shariah experts?



The Shariah board has a unique relationship with Islamic financial institutions (IFIs), as they are responsible for monitoring the compliance of Shariah rules in their transactions and the issuance of Shariah products. The members of the Shariah board are made up of unique individuals who have knowledge of both Islamic Jurisprudence and finance and a strong commitment to developing Islamic Financial Institutions within the Shariah framework.

Referring to the IFSB-3 the concept of corporate governance in IFIs is a set of organisational arrangements whereby the actions of the management of institutions offering Islamic financial services are aligned, as far as possible, with the interest of its stakeholders; provision of proper incentives for the organs of governance such as the Board of directors (BOD), Shariah Supervisory Board and management to pursue objectives that are in interests of stakeholders and facilitate effective monitoring, thereby encouraging IIFS to use resources more efficiently; and comply with Islamic Shariah rules and principles" (IFSB, 2006, pp.33).

According to the Islamic Financial Services Board, Shariah Governance Framework refers to the set of institutional and organisational arrangements

through which Islamic financial institutions ensures that there is effective independent oversight of Shariah compliance over each of the following structures and processes:

1. The issuance of relevant Shariah pronouncement/resolutions
2. Dissemination of information on Shariah resolutions to the operative personnel of the Islamic financial institution
3. An internal Shariah compliance review or audit
4. Annual Shariah compliance review or audit for verifying the internal Shariah review.

The fact that 84% of the respondents said that independent Shariah experts did not audit the Shariah board decisions in their organisation is quiet alarming.

According IFSB Principle 2.3: There should be a formal assessment of the effectiveness of the Shariah board as a whole and of the contribution by each member to the effectiveness of the Shariah board.

Accountability is one of the fundamental beliefs of Islam.

The Quran says,

“If anyone does an atom’s weight of good shall see it in Allah’s court, and if anyone does an atom’s weight of evil shall also see it”

[Al-Quran Surah 99: Verses 7-8]

The Prophet (PBUH) is reported to have said,

“Every one of you is a shepherd and every one of you is answerable with regard to his folk”.

Allah commanded the Prophet (PBUH) to declare:

“I would, if I disobeyed my Lord, indeed have fear of the penalty of a Mighty Day”

[Surah 6 Ayah 15; Surah 10 Ayah 15; Surah 39 Ayah 13]

No one is above the law of Allah.

The Prophet (PBUH) said,

“I am the first one to submit to the will of Almighty”

[Surah 6 Ayah 14]

Abu Bakar, the first caliph of Islam announced said in his inaugural speech:

“I have been given authority over you but I am not the best of you. If I do well, help me, and if I do ill, then put me right...The weak among you shall be strong in my eyes until I secure his right if God will; and the strong among you shall be weak in my eyes until I wrest the right from him...Obey me as long as I obey God and His apostle, and if I disobey them you owe me no obedience”

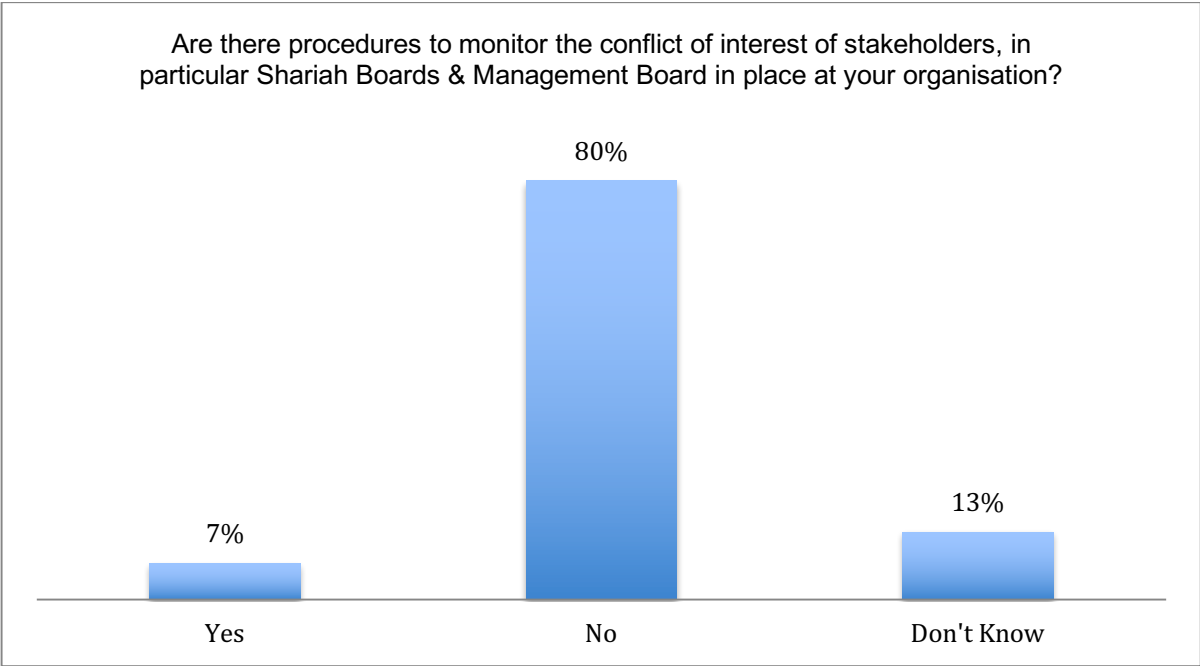
[A. Guillaume, “The Life of Muhammad”]

Accountability leads to improved decision making and to an improvement in performance and similarly it weeds out incompetence and mistakes. Holding the self to account is from Islam, how is it that those who provide Shariah rulings, which are from the law of Allah, do not hold their opinions to account?

Do the boards believe that they are above accountability? The Prophet Muhammad (PBUH), the first caliph of Islam Abu Bakr, and the general Muslims will be held to account. This is what Allah has declared for all humans in this life, so why not the opinions of the boards be held to scrutiny by others? Do the Shariah believe that their decisions are perfect and unquestionable under any circumstances? Do they

believe that there is no besides them who is capable or worthy or scrutinising these opinions? Why do the companies not insist on their opinions being reviewed and scrutinised?

Survey Question: Are there procedures to monitor the conflict of interest of stakeholders, in particular Shariah Boards & Management Board in place at your organisation?



OECD Principle VI.D.6: Monitoring and managing potential conflicts of interest of management, directors and shareholders, including misuse of corporate assets and abuse in related party transactions.

“It is an important function of the board to oversee the internal control systems covering financial reporting and the use of corporate assets and to guard against abusive related party transactions. These functions are sometimes assigned to the internal auditor, which should maintain direct access to the board. Where other corporate officers are responsible such as the general counsel, it is important that they maintain similar reporting responsibilities as the internal auditor.

In fulfilling its control oversight responsibilities, it is important for the board to encourage the reporting of unethical/unlawful behaviour without fear of retribution. The existence of a company code of ethics should aid this process. Which should be underpinned by legal protection for the individuals concerned. In a number of companies either the audit committee or an ethics committee is specified as the contact point for employees who wish to report concerns about unethical or illegal behaviour that might also compromise the integrity of financial statements. “ (OECD)

The fact that 80% of the respondents said that there was no procedure to monitor the conflict of interest of stakeholders; in particular Shariah Boards & Management Board at their institution is worrying. This has closed the gates of transparency, and opened the doors to possible dishonesty and untruthfulness. This goes against all the established Islamic principles, and should be addressed immediately.

Fama and Jensen (1983) mention mutual monitoring, accounting, and budgeting systems as critical for ensuring that management's decisions are made with the interests of the shareholder in mind, and compliance with applicable laws and regulations (Kinney, 2000). The success of the management or internal control can affect the possibility of employee misconduct in a firm. Russell (1995) argues that widespread corporate fraud often requires a failure in internal control or operational governance systems.

There is a correlation on the main issues facing these organisations and the industry in general at this moment in time. They are:

The top 4 are very much the same for all organisations,

1. Accountability
2. Conflict of interest
3. Transparency
4. Lack of independence of Shariah Board

Others include:

1. Confidentiality
2. Lack of proper Corporate Governance infrastructure
3. Due diligence
4. Lack of standardization of views from Scholars
5. Extremely high legal threat for products which are not covered by any law
6. Lack of participation
7. Greater accountability on decision-making
8. Education of Shariah board
9. Lack of relevant knowledge
10. Review of decisions

Chapter 6: Compiling a coherent code, Islamic principles & regulations for Corporate Governance

The following research questions were posed at the start of this research:

1. What does the Islamic system of life mean for corporate governance of financial institutions?

In summary, Islamic Financial Institutions need to comprehend the objectives, role and purpose of the Shariah, and do they?

2. How do Islamic principles apply to corporate governance?
3. What regulations and guidelines does the Shariah provide to regulate corporations?

In summary, Identify the problems that the organisation is facing with regards to corporate governance issues that are specifically related to the Shariah and look at the guidelines provided to address them.

4. How does the Islamic Corporate governance approach compare with the conventional approach to corporate governance?

In summary, Islamic Financial Institutions need to appreciate the importance of good corporate governance

5. Is there a convergence in the approaches to corporate governance (Islamic and conventional) or is there divergence?
6. If approaches are 'divergent', how can the divergences be utilized in order to govern corporations on an Islamic basis? What standards need to be laid down if approaches are convergent?

This chapter will attempt to address these questions in the light of the research undertaken and the analysis of the survey implemented. The Primary Research objectives of this research which have been addressed in this chapter, have included,

- To identify the specific corporate governance issues / problems facing IFI's.
Does an Islamic way of life provide a solution to these corporate governance issues / problems?
- To identify specific Shariah related corporate governance issues / problems.

How do Islamic principles, if at all, apply to corporate governance? Why is it that these problems exist for IFI's if there are Islamic principles that do provide a solution?

- To identify potential solutions for these issues / problems from an Islamic angle. Are there guidelines setup that provide solutions from Shariah principles? Who has set them up and why do these problems still persist?

The secondary research objective of this research which has been addressed in this chapter is:

- Is it really a problem of a lack of good corporate governance principles or is it negligence in implementation of these principles by IFI's?
- Are there state / government implemented approaches to corporate governance for IFI's that eliminates these problems in certain geographical regions?

The aim of this chapter is to address the research questions raised and also to elucidate the duties that become compulsory on a person once he / she accepts Islam. The author will attempt to substantiate some of these duties, relevant to this research, upon a Muslim and then endeavor to prove how business dealings and actions and activities also fall into the realms of duties of a Muslim.

Islam is a way of life, and not something you profess and then do, as you like. Once you accept Islam as a way of life, then you have to abide by the rules and regulations that Allah has laid out for the Muslim, and undertake these compulsory duties and responsibilities. These fall into all spheres of life. It is not just sitting in a masjid praying, nor is it simply reciting Quran and neither does it involve living like a hermit. Once the author has proven some of the duties upon a Muslim, and in particular those in the business field; it will become clear that the field of business and work is just as important as worship in Islam, as are other duties.

Allah will reward a person for them, as there is punishment involved if these duties are neglected willfully or manipulated in a manner that leads to harm for other people.

A person joins the fold of Islam by sincerely believing in and professing faith in the oneness of Allah and the Prophethood of Muhammad (peace and prayers of Allah be upon him), embodied in the article of faith, "There is None worthy of Worship except Allah and Muhammad is the Messenger of Allah". When pronounced by an individual sincerely enters him / her into the fold of Islam, but this has conditions attached to it which differentiates the person who will benefit from making this statement from one who will receive no benefit.

The word Islam is a verbal noun originating from the triliteral root s-l-m, and is derived from the Arabic verb Aslama, which means, "to accept, surrender or submit." Thus 'aslamaamrahu ila Allah' means "he committed his cause to Allah" or "he resigned himself to the will of Allah." Aslama alone would mean "he committed himself to the will of Allah" or "he became a Muslim." Thus, Islam means acceptance of and submission to Allah, and believers must demonstrate this by worshipping Him, following His commands, and avoiding polytheism. The other major shade of meaning in the root is "to become reconciled with one another" or "to make peace." Salm means "peace." So does silm, which also means "the religion of Islam."

[Hans Wehr, A Dictionary of Modern Written Arabic]

Ibn Manzoor al-Africee al-Misree, the author of Lisanul-Arab states that Islam linguistically means 'submission'. Technically it means, 'To profess submission and to acknowledge the Shariah, and to be devoted to that which was revealed to the Prophet peace and prayers of Allah be upon him')

[Lisan Al-Arab by: Ibn Manzur Volume 7-8 Page 243 [Published: Dar Sader Beirut Lebanon 4th Edn 2005. Translated by the author]

Abu Bakr Muhammad bin Bashaar in Lisan Al Arab, translated into English by the author, commented on the technicality of Islam; when it is said that so and so is a Muslim, then it refers to one of two opinions:

1. He is submissive to the command of Allah
2. He is sincere to Allah with al-Ibaadah

There are many implications upon the life of a person once he / she accepts the deen of Islam. These duties can be separated into 2 main categories:

- i. Rights of Allah
- ii. Rights of the People

Islam is a complete way of life, and as such it demonstrates to an individual how to deal with all aspects of life, including guidance in business behaviour.

Allah, stated in the Quran:

“It is He Who brought you forth from the wombs of your mothers when ye knew nothing; and He gave you hearing and sight and intelligence and affections: That ye may give thanks (to Allah)”

[Surah 16 Ayah 78]

If Allah stopped His care for only a few moments, our entire world would collapse, in order to prevent such a catastrophic collapse of the universe, the only thing that Allah demands from His creation is to worship Him alone without any association of others in the worship.

Allah stated in the Quran:

“I have only created Jinn and men, that they may serve Me. No sustenance do I require of them, nor do I require that they should feed Me “.

[Surah 51 Ayah 56-58]

Worship of Allah is not mere formalism, neither is it limited to the performance of certain religious acts, the concept of 'worship' in Islam is much more comprehensive than the commonplace meaning ascribed to the term. Every action performed is worship when it meets two fundamental conditions:

- (i) To be done with 'pure' intention
- (ii) To be done within the limits prescribed by Allah.

Since Allah has created humans to worship Him, then he must have specified humans with a way to worship Him and indeed Allah has provided a way to follow His religion. A way that is comprehensive and does not leave a single stone unturned when guiding mankind. Allah has provided guidance through the Quran and the Sunnah of Prophet Mohammad for worshipping Him in all walks of life. The guidance of Allah is so comprehensive; it guides the Muslim from the simple everyday act of going to the bathroom as well as guidance on how to behave with rulers.

There was a polytheist who exclaimed with amazement to Salman, the Persian,

“Your Prophet has taught you everything, even how to defecate!”

Salman responded,

“Yes, he forbade us to face the direction of Mecca when urinating or defecating...”

[Al-Tirmidhi]

So the messenger came and provided guidance for all aspects of life, from the smallest action that seems insignificant to the most significant in the life of a human being. The aspect of the business life of a Muslim, one of the most important, has likewise not been overlooked by Allah, for He has provided guidance on this also, for example

Allah in Holy Quran says:

Do not devour one another's property wrongfully, nor throw it before the judges in order to devour a portion of other's property sinfully and knowingly.

[Surah Baqarah Ayah 188]

"And measure full when you measure. And weigh with an even balance. This is better and its end is good."

[Surah Al-Bani-Israel Ayah 35]

"O Believers! Whenever you lend money for a particular period, write and someone among you must write it justly. And the one who can write must not refuse."

[Surah Baqara Ayah 282]

Life is seen as an integrated and interrelated whole that includes moral, social, economic, political as well individual and collective pursuits. One of the main challenges to humanity is to relate and blend such activities under divine guidance. This right that Allah, requires for Himself from man is very easy to observe, simple to respect, clear to understand and practical to apply. The result and fruit of this belief in Islam is dedication, sincerity and full devotion to the truth, to justice, and leads to ethical and moral practice.

The Prophet peace and prayers of Allah be upon him) said,

"The lawful is clear, and the unlawful is clear. But between the two are ambiguous matters not known to many people. Whosoever avoids these matters has preserved his honour and his religion intact. But whosoever falls into them shall fall into the unlawful, in the fashion of a shepherd who pastures his flock around a sanctuary, so that he is near to violating it. Assuredly, every king has a sanctuary, and Allah's sanctuary on this earth is composed of his prohibitions."

[Bukhari and Muslim]

The meaning of this is that the completely permissible is clear, there is no confusion in it and the entirely prohibited is clear. However, between these two matters are matters about which it is difficult for many people to distinguish the permissible and the prohibited.

“Like the shepherd who pastures around a sanctuary, all but grazing therein. Verily, every king has a sanctuary, and Allah’s sanctuary is His prohibitions.”

This is a parable which the Prophet (peace be upon him) used for whomever falls into uncertain matters, for it brings him closer to falling into what is absolutely unlawful. The Prophet (peace be upon him) compared the prohibitions to a sanctuary which is protected by the king, who prevents others from coming close to it. Likewise, Allah forbids contravening His prohibitions and prevented His slaves from coming close to them, and called them Allah’s boundaries, saying,

“These are the limits (set) by Allah, so approach them not. Thus does Allah make clear His ayah (proofs, evidences, lessons, signs, revelations, verses, laws, legal and illegal things, Allah’s set limits, orders, etc.) to mankind that they may become the pious.”

[Surah Al-Baqarah Ayah 187]

This clarification defined what he made permissible for them and what he prohibited to them, so that they would not come close to the prohibited or go beyond the permissible. This is what He said in another verse that reads,

“These are the limits ordained by Allah, so do not transgress them. And whoever transgresses the limits ordained by Allah, then such are the wrong-doers.”

[Surah Al-Baqarah Ayah 229]

The Rights of the Prophet

There are no rights for any man on the face of the Earth, for a Muslim, greater than the rights of the Prophet (peace and prayers of Allah be upon him), Allah, stated in the Quran:

“We have truly sent thee as a witness, as a bringer of Glad Tidings, and as Warner: In order that ye (O men) may believe in Allah and His Apostle, that ye may assist and honor Him, and celebrate His praises Morning and evening”.

[Surah Al Fath Ayah 8-9]

It is a must that love, care and full respect must be given to Allah's Prophet (peace and prayers of Allah be upon him), especially over all other people. Allah's Prophet (peace and prayers of Allah be upon him) said:

“One will not become a complete believer until Allah's Prophet becomes more beloved to him than his own children, parents and all other people “.

[Bukhari and Muslim]

One of the rights of the prophet (peace and prayers of Allah be upon him) upon us Muslims is to believe him fully and wholeheartedly in whatever he brings of the news and reports of Divine inspirations.

Allah, stated in the Quran:

“But no, by thy Lord, they can have no (real) Faith, until they make thee judge in all disputes between them, and find in their souls no resistance against thy decisions, but accept them with fullest conviction.”

[Surah 4 Ayah 65]

Surah 4 Ayah 65 necessitates obeying the Prophet (peace and prayers of Allah be upon him) by Allah, which in turn becomes the rights of the prophet over the Muslims.

Allah stated in the Quran:

“Say: “If ye do love Allah, follow me: Allah will love you and forgive you your sins: For Allah is Oft-Forgiving, most merciful.”

[Surah 3 Ayah 31]

This Ayah judges against those who claim to love Allah, yet do not follow the way of Prophet Muhammad. Such people are not true in their claim until they follow the Shariah of Prophet Muhammad and his religion in all his statements, actions and conditions.

The Qur'an speaks of the importance of following the Prophet,

“He who obeys the Messenger has indeed obeyed Allah . . .”

[Surah al-Nisaa' Ayah 80]

Allah described obedience to the Prophet (peace and prayers of Allah be upon him) as being a part of obedience to Him,

“O you who believe! Obey Allah and obey the Messenger . . .”

[Surah al-Nisaa Ayah 59]

To Obey Allah involves obeying the Messenger of Allah.

The Rights of the Governors and the People

Governors or rulers are all those responsible for any organization in the government and Allah required the general public to obey the commands and instructions of their leaders.

Allah, stated in the Quran:

“O ye who believe! Obey Allah, and obey the Apostle, and those charged with authority among you”.

[Surah 4 Ayah 59]

Allah has made it compulsory to obey Him and the Prophet (PBUH), but he says,

“and those”

Which means to obey the rulers is only as long as they obey Allah and there is no obedience to the leaders when it involves disobeying Allah. The general public must assist their governors in achieving their missions and fulfilling their tasks and duties. Each and every citizen must know the importance of his role in society, and consequently in the government in general. If individuals fail to realize their duties and responsibilities, the situation will turn into chaos and confusion. It is only natural to have the commitment of the people and public for the administration to lead a decent government. Islam requires the full support of the general public for the governor as long as the governor follows the tenants of Islam.

The Right of the Muslim

The general rights are for the welfare and wellbeing of Muslims at large, and are instituted for a better society, much improved social relations, stronger ties and better citizenship. The rights that one Muslim has over another are many, some of which are individual obligations that are required of each person, others are communal obligations; if some people do them, the burden of sin is waived for the

rest of the society. And some are encouraged but not obligatory, so the Muslim is not sinning if he does not do them.

Al-Bukhari and Muslim narrated,

“The rights of one Muslim over another are five:

1. Returning the greeting of salaam
2. Visiting the sick
3. Attending funerals
4. Accepting invitations
5. Saying yarhamuk Allah (may Allah have mercy on you) to one who sneezes.”

[Al-Bukhari and Muslim]

And Muslim narrated:

“The rights of one Muslim over another are six.”

It was said:

What are they, O Messenger of Allah?

He said:

1. “If you meet him, greet him with salaam
2. If he invites you, accept the invitation
3. If he asks for advice, give him sincere advice
4. If he sneezes and praises Allah, say Yarhamuk Allah (may Allah have mercy on you)
5. If he falls sick, visit him
6. If he dies, attend his funeral.”

[Muslim]

The Messenger of Allah (peace and prayers of Allah be upon him) said:

"A believer to another believer is like a building whose different parts enforce each other."

The Prophet then clasped his hands with the fingers interlaced while saying that.

[Bukhari & Muslim]

The Prophet (peace and prayers of Allah be upon him) draws parallels to explain some issues; he likens the mutual assistance and solidarity of believers to the enforcement of the parts of a building.

The Prophet (peace and prayers of Allah be upon him) said,

"A Muslim is the brother of another Muslim. He does not betray his brother, lie to him and leave him unassisted. The chastity, property and blood of a Muslim are haram for another Muslim."

[Tirmidhi]

Betrayal is the opposite of trustworthiness, and includes all kinds of injustice, lack of trust and confidence. A Muslim does not betray what is entrusted to him.

The Quran says:

"The Believers are but a single Brotherhood..."

[Surah al-Hujurat Ayah 10]

A person may encounter various problems, big or small, in daily life, everything that pains man is a problem. Muslims help one another to overcome these problems, and they receive reward from Allah when they remove the problems of their brothers just like when they meet their needs. Those who do good deeds in the world will receive their reward on the Day of Judgment.

It is imperative therefore that one Muslim does not do injustice to another in his / her business dealings. When one person has authority or influence over the others in the business field, then they must ensure that they always act equitably and never harm another.

Allah says in the Quran,

‘O people! We created you from one man and one woman and made you divided in branches and tribes so that you may recognize one another. Undoubtedly the most respected among you in the sight of Allah is he who is more pious, verily, Allah is knowing, Aware.

[Surah Al-Hujurat Ayah13]

Towards Family & relatives

Relatives have specific rights entitling them to special attention, visitation and support in times of need and to share in their concerns. Islam encourages a Muslim to be kind to his relatives even when they are unkind to him, and asks him to continue his relations even when they cut them off. Everyone who has a tie of relation with you has certain rights upon you,

Allah said:

“And give to the relative his right.”

[Surah al-Israa Ayah 26]

Allah also said:

“And worship Allah alone, and do not set-up any partner to Him in worship, and be kind and good to the parents, and to the relatives.”

[Surah an-Nisaa Ayah 36]

So it is obligatory upon everyone to treat their relatives in the best possible

manner, and to support them in accordance with their needs, and what they seek of help and support.

The Prophet (peace and prayers of Allah be upon him) said:

“The best charity is that which is practiced by a wealthy person. And start giving first to your dependents.”

[Bukhari]

The Prophet (peace and prayers of Allah be upon him) said:

“To give something to a poor man brings one reward, while giving the same to a needy relation brings two: one for charity and the other for respecting the family ties.”

[Ahmad, Ibn Majah, Nasai, Tirmidhi]

The Prophet (peace and prayers of Allah be upon him) said:

“Whosoever believes in Allah and the Last Day let him keep the ties of relations.”

[Bukhari Hadith No.6138]

Towards Society

“Surely Allah commands justice and the doing of good (to others), and giving to the kindred, and He forbids indecency and evil and rebellion. He admonishes you that you may be mindful. And fulfill the covenant of Allah, when you have made a covenant, and break not your oaths after confirming them; and you have indeed made Allah your surety. Surely Allah knows what you do.”

[Surah 16 Ayah 90-91]

These ayahs certainly train a Muslim in the finest behaviour in order for them to form a strong society, by ordering justice among the people. The Qur'an explains

that it is obligatory for Muslims to practice justice in both their deeds and their speech so no one will be deprived of his / her right.

The Messenger of Allah (peace and prayers of Allah be upon him) said:

“Do not envy one another, and do not inflate prices for one another, and do not hate one another, and do not turn away from one another, and do not undercut one another in trade, but [rather] be Slaves of Allah and Brothers [amongst yourselves]. A Muslim is the brother of a Muslim: he does not oppress him, nor does he fail him, nor does he lie to him, nor does he hold him in contempt.”

[Hadith No 35 Imam an-Nawawi's 40 Hadith]

The Messenger of Allah (peace and prayers of Allah be upon him) said:

The Lord's commandment for every one of His slaves is, 'Spend on others, and I will spend on you'.

[Bukhari & Muslim]

He also said:

“Have you seen him who belies the rewards and punishments of the Hereafter? He it is, who drives away the orphan and does not urge giving away the food to the poor.”

[Surah Al-Ma'un Ayah 1 – 3]

The Messenger said,

“If any Muslim plants something or sows seed from which a man, a bird or an animal eats, it counts as a charity for him.”

[Bukhari & Muslim]

The Shariah does not confine itself to giving rights to Muslims only, the general principle is that non-Muslims have the same rights and obligations as Muslims. Islam emphasizes the origin of all humanity is one; therefore all human beings have certain rights over one another.

Allah says:

"O mankind! We created you from a single (pair) of a male and female, and made you into nations and tribes, that you may know each other (and not hate one another). Surely, the most honored of you in the sight of God is (he who) is the most righteous of you. And God has full knowledge and is well acquainted (with all things)."

[Surah 49 Ayah 13]

It is clear that there are rights and duties towards the society at large, and a Muslim cannot neglect them and nor seize to be a part of the society.

Rights of the Employees

Islam has defined a set of rules on labour and the labour force. An employer, according to Islamic teachings, must establish a just and cordial relationship with his employees and the labour force. Such a relationship must be based on equality, goodwill and the brotherhood of Islam.

The prophet (peace and prayers of Allah be upon him) is reported to have said,

"The best of income is that which results from honest labour".

[Musnad Ahmad, Hadith no. 8419]

The Prophet (peace and prayers of Allah be upon him) said,

“The honest treasurer who gives willingly what he is ordered to give is one of the two charitable persons, (the second being the owner).”

[Mishka'at]

The employees have rights over their employers and vice versa.

Rights of the Employers

Islam equally requires workers to maintain good relations with their employer, and fulfill their duties towards their employer to the best of their abilities. Workers must not neglect or harm their employer or his work in any way.

In order to encourage sincerity in work and to protect one's dignity, Islam made the earning of a laborer the best of all earnings if he were sincere in his work.

Prophet Muhammad (peace and prayers of Allah be upon him) said:

“Give the labor his wage before his sweat dries”

[Ibn Majah]

He also said:

“Those are your brothers [workers under you] who are around you; Allah has placed them under you. So, if anyone of you has someone under him, he should feed him out of what he himself eats, clothe him like what he himself puts on, and let him not put so much burden on him that he is not able to bear, [and if that be the case], then lend your help to him.”

[Bukhari, No: 2359]

He also said:

“I will be foe to three persons on the Last Day: one of them being the one who, when he employs a person that has accomplished his duty, does not give him his due.”

[Bukhari, No: 2109]

The Prophet (peace and prayers of Allah be upon him) said:

“The best earning is that earned against the labour of the hand with sincerity”

[Ahmad, Hadith no.8393]

It is clear that the duties upon a Muslim are widespread, the duty towards the society in general, as well as in business transactions ensures that the complete life of a Muslim is a form of worship to Allah, as such guidance has been revealed to show how a Muslim must go about them. This unique concept of worship in Islam is unparalleled and combines the mundane with the spiritual and the individual with the society. Worship in Islam has many features, the most general being inclusive of everything which is pleasing to Allah. It also refers to everything that Allah requires, including rituals as well as beliefs, work, social activities, and personal behaviour, as a human being is a whole, such that every part affects every other.

Therefore, devoting oneself to Allah in Islam does not require a person to enter a place of worship nor embrace monasticism; rather, fulfilling this purpose of life is an active daily pursuit. A Muslim can be engaged in worship throughout the day, be it at home, work or anywhere else.

Allah says in the Quran that to fulfill promises and commitments,

“And keep the covenant. Lo! Of the covenant it will be asked.”

[Surah Al-Israa Ayah 34]

Promises and contracts are an important part of human life and human civilization and a form of worship. When promises are not kept, trust is lost and the whole society becomes weak. The Islamic understanding of worship allows the whole of one's life to be an act of worship, as long as the objective of that life is the pleasure of Allah. A person can turn everyday activities into acts of worship by purifying their intention and sincerely seeking Allah's pleasure through these activities. Business transactions fall into these categories, and hence a Muslim must be conscious of

them at all times. He / she must be clear about his / her responsibilities and act according to the guidance revealed by Allah, and shown by the Shariah.

The issue of corporate governance falls into this category, as it is a multi-faceted right upon the Muslim. There are many stakeholders involved in corporate governance, which are also the same stakeholders that the Muslim owes an obligation towards. They involve Muslims, neighbour's, relatives, rulers and society as a whole. This necessitates that corporate governance is undertaken as an act of worship, as the person will be held accountable for them.

The day of judgement will come and it will hold a person accountable for all his / her actions, and this will include those of corporate governance activities. And for every stakeholder who feels they have been wronged by the individual due to their corporate governance activities, which might be due to a lack of transparency or honesty, then they will have recourse in front of Allah. And if these activities fall short of expectations, then there will be accountability and if they are as they should be, then there will be reward from Allah for the act of worship that has been undertaken.

Allah says in the Quran,

“Give full measure when ye measure, and weigh with a balance that is straight: that is the most fitting and the most advantageous in the end.”

[Surah Al-Israa Ayah 35]

Honest business brings progress, success, and blessings. All business, whether commercial, social, or political must be done with a sense of justice and fairness.

Man is Allah's viceregent on Earth:

The acceptance of Islam represents an agreement between the individual and Allah, where the model of the human has a duality of functions in the form of 'Worshipper' and the 'Vicegerent'. Human beings have a unique position in creation, as they have been designated as the vicegerent (Khalifa) of Allah on

earth. Khalifa means someone who takes the place of another in his absence or as an agent of the absolute owner (Asvat, 2011, p. 18).

Man is the vicegerent of Allah on Earth (Surah al-Baqarah Ayah 30) and is not left without a purpose (Surah al-Qiyamah Ayah 36) according to the Creator. The Quran states that man was created as “the vicegerent on earth” [Surah al-Baqarah Ayah 30; Surah al-An‘am Ayah 165; Surah Faatir Ayah 39] and this expression is usually interpreted as “being the vicegerent of the Creator, that is, ruling the world in compliance with His laws”.

The word vicegerent means to improve the world for and on behalf of Allah, to apply the orders and recommendations of Allah on Earth. Humans are seen as unique and privileged beings who are able to be caring, responsible, kind, just, wise, forgiving, and display many embedded good qualities.

Islam strongly advocates all forms of positive governance. Islamic values expressed in ethical conduct are an integral part of the obligations laid upon the individual and the community. Rules of corporate governance derive from the underlying principle of assuring the economic wellbeing of the whole community on the basis of universal brotherhood, justice, honesty, fair dealing, avoidance of exploitation, mutual accountability, truthfulness and transparency, protection of minorities, adequate disclosure and equitable distribution of wealth.

Islam commands authority over the totality of a Muslim’s being and behaviour, without any concession of special provision for ‘sacred’ and ‘secular’ domains. The two dominant factors that shape the nature of Islamic corporate governance, the Shariah, claims sovereignty over all aspects of conduct, individual and collective, and to encompass civil as well as criminal jurisdiction and the law includes certain economic and financial principles that have a direct bearing on corporate practices and policies.

The Islamic concept of corporate governance emphasizes the traits that Allah expects in people: accountability, transparency, and trustworthiness (Mustapha and Salleh 2002). According to Islam, a company’s managers and staff, by virtue of

their individual responsibility to Islamic principles, are accountable to the shareholders, customers, regulatory bodies, and society at large. Tawhid encourages self-governance promoting the need to submit fully to Allah, and focuses on the unique relationship between people and Allah.

Acting responsibly toward others and being responsible for oneself is a trust, neglecting personal and social responsibilities is a form of betrayal in the eyes of Allah. Muslims are called to be dedicated to their work, as it is a form of worship and are viewed as virtuous acts. Acting with integrity is required of a practicing Muslim under the principle of Khalifa (trusteeship). All of these aspects of Islam support the goal of strong corporate governance.

Shariah governs Islamic Financial Institutions just as it governs individuals and their actions. The aim of Shariah for financial institutions is to support Islamic financial practices that do not exploit or do injustice to the institution's shareholders and customers.

Three basic elements of the Islamic faith provide the foundation for corporate governance in Islamic banking (Haron and Shanmugam 1997):

- I. Aqedah, concerns faith and belief in Allah
- II. Shariah, concerns practical actions taken by Muslims in manifesting their faith and beliefs
- III. Akhlaq, covers a Muslim's behaviour, attitude and work ethic

Regulations for Islamic Corporate Governance

Strong corporate governance in Islamic financial institutions is fundamental for the progression of a vibrant and comprehensive Islamic finance industry. The regulation of Islamic finance needs to be aligned with the regulation of conventional finance consistent with Shariah requirements. This means the application of internationally recognized regulatory standards and principles with variations only as necessitated to reflect Shariah compliance.

Banking and finance regulation and supervision are a vital factor for economic development, efficiency, and stability with the necessity for the supervisory authorities to conduct persistent checks on compliance with these regulations. Regulation in the Islamic banking and finance industry is essential to preserve confidence in the system as a whole, helping increase the information available to investors, protecting interests of savers and ensuring the soundness of the financial system.

International reforms implemented in bank regulation and supervision, such as Basel II regime, developed an extensive list of best practices that have important implications for Islamic banks. The adoption of sound corporate governance standards and practices ensures that Islamic banks are managed safely and soundly where risk taking activities and business prudence are properly balanced to and safeguard the interests of all stakeholders.

If the corporate governance code for Islamic financial Institutions is made mandatory by law by the regulatory authorities where they are located, and they issue standards for compliance with all laws and regulations and also the responsibility pertaining to corporate governance. If the Islamic financial institutions nominate a high level officer responsible for following through the implementation of the corporate governance practices, this will improve confidence in the institution.

In comparison with conventional banking and finance, Islamic financial institutions have an added Shariah board or Shariah supervisory board (SSB) in their layer of governance, and typically international Shariah review and compliance units and for some institutions an external Shariah review unit. These should, if implemented carefully and thoroughly improve confidence in the industry.

The IFSB published the Guiding Principles on Shariah Governance systems for Institutions Offering Islamic Financial Services in 2006, which were designed to help them establish and implement effective corporate governance practices.

These IFSB Guiding Principles are applicable to:

- 30 Commercial banks
- 31 Investment banks
- 32 Finance houses
- 33 Other fund-mobilizing institutions that offer only financial services and products complying with Islamic Shariah rules and principles

The IFSB principles are divided into four parts:

- 29. General governance approach of Islamic financial institutions
- 30. Rights of investment account holders (IAH)
- 31. Compliance with Islamic Shariah rules and principles
- 32. Transparency of financial reporting in respect of investment accounts

In addition, the Accounting and Auditing Organizations for Islamic Financial Institutions (AAOIFI) has also issued numerous accounting and auditing standards, many governance standards and codes of ethics as well as many Shariah standards.

Compiling a coherent code of Islamic Corporate governance

There are numerous Islamic corporate governance-guiding principles available across the globe. Some companies, due to the location and national regulatory body, come under legal jurisdiction of a country that has adopted the IFSB Islamic corporate governance practices; whilst others fall outside such jurisdictions and therefore follow them voluntarily, if at all.

These countries that follow IFSB guiding principles as a matter of law, have extensive Islamic corporate governance codes to follow, and others that do not follow IFSB guiding principles as law, but have their own Islamic corporate governance guiding principles as law. Companies who fall outside these jurisdictions will follow the corporate governance principles adopted in their jurisdictions, whether they are OECD principles or those from the country itself. It is

clear that many Islamic financial institutions fall outside in countries that do not have Islamic corporate governance principles as law, and therefore only adopt them if they wish to.

The author believes the problem is not so much in having these principles, but rather with actually following and obeying them. The problem lies with the practice and not the theoretical principles.

What are the key principles of Islamic corporate governance?

According to the IFSB,

- **General Approach to the Shariah Governance System**

1. Principle 1.1: The Shariah governance structure adopted by the IIFS should be commensurate and proportionate with the size, complexity and nature of its business.
2. Principle 1.2: Each IIFS must ensure that the Shariah board has:
 - a. Clear terms of reference regarding its mandate and responsibility
 - b. Well-defined operating procedures and lines of reporting
 - c. Good understanding of, and familiarity with, professional ethics and conduct

- **Competence**

1. Principle 2.1: The IIFS shall ensure that any person mandated with overseeing the Shariah Governance System fulfills acceptable fit and proper criteria
2. Principle 2.2: The IIFS shall facilitate continuous professional development of persons serving on its Shariah board, as well as its ISCU and ISRU, if any
3. Principle 2.3: There should be a formal assessment of the effectiveness of the Shariah board as a whole and of the contribution by each member to the effectiveness of the Shariah board

- **Independence**

1. Principle 3.1: The Shariah board should play a strong and independent oversight role, with adequate capability to exercise objective judgement on Shariah related matters. No individual or group of individuals shall be allowed to dominate the Shariah board's decision-making
2. Principle 3.2: In order to fulfill their responsibilities, the Shariah board should be provided with complete, adequate and timely information prior to all meetings and on an ongoing basis

- **Confidentiality**

- Principle 4.1: Shariah board members should ensure that internal information obtained in the course of their duties is kept confidential
- **Consistency**
- Principle 5.1: The IIFS should fully understand the legal and regulatory framework for issuance of Shariah pronouncements/resolutions in the jurisdiction where it operates. It should ensure that its Shariah board strictly observes the said framework and, wherever possible, promotes convergence of the Shariah governance standards

The above 4 are general principles of Islamic corporate governance as outlined by the IFSB in “Guiding Principles On Shariah Governance Systems For Institutions Offering Islamic Financial Services”, 2009.

They can be elaborated further,

- **Decision-making / Shura**

Proof of this being the ayah from the Quran,

“And consult them on affairs [of moment]. Then, when you have taken a decision, put your trust in Allah”

[Surah Al-Imran Ayah 159]

- **Accountability**

Proof of this being the ayah from the Quran,

“O ye who believe! Betray not the trust of Allah and the apostle, nor misappropriate knowingly things entrusted to you.”

[Surah al-Anfal Ayah 27]

If the Islamic financial institutions were to follow the IFSB rules as specified above to the letter of the law, then the author believes that confidence in the Islamic financial institutions would be much higher. At the moment although many claim to abide by IFSB guiding principles and pay lip service to the principles of Islamic corporate governance, they clearly violate or disregard or choose to circumvent certain principles. For example, competence of the Shariah scholars is a point well

known by all, as are issues of being independent and showing accountability for the members of the board.

The OECD Principles of Corporate Governance were endorsed by OECD Ministers in and have since become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. They have advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non-OECD countries (OECD, 2009). Just as in the OECD principles, the underlying fundamentals emphasized in Islam are transparency, consistency and equality in exercising the law.

The following are the main areas of the OECD principles,

Principle 1: Ensuring the basis for an effective corporate governance framework

Principle 2: The right of shareholders and key ownership functions

Principle 3: The equitable treatment of shareholders

Principle 4: The role of stakeholders in corporate governance

Principle 5: Disclosure and transparency

Principle 6: The responsibilities of the board

The main theme of the above principles fall in four basic areas,

- Business ethics
- Decision making
- Adequate disclosure and transparency
- The mechanism of book keeping and final accounts

[Morck \(2005\)](#) states that the soundness of the OECD principles has been proven by their adoption all over the world.

Table 3 Comparison of Islamic CG Principles with OECD principles

OECD principles and annotation	Islamic principles
Principle 1: Insuring the basis for an effective corporate governance framework	
<ul style="list-style-type: none"> • Promotion of transparent & efficient markets with rule of law & division of responsibilities 	<ul style="list-style-type: none"> • Promotion of business within ethical framework of Shariah • Belief in profit and loss • Primacy of Justice & social welfare with social and spiritual obligations • Prohibition of interest
Principle 2: The rights of shareholders & key ownership functions	
<ul style="list-style-type: none"> • Basic shareholder rights Participation in Decision-making at the general meetings • Structures & arrangements markets for corporate control • Ownership rights by all shareholders including institutional shareholders • Consultative process between shareholders 	<ul style="list-style-type: none"> • Property as trust from Allah • Sole Authority is Allah • Society as stakeholders • Accountability not only to stakeholders but also to Allah, the ultimate owner
Principle 3: The equitable treatment of shareholders	
<ul style="list-style-type: none"> • Protection to minority and foreign shareholders 	<ul style="list-style-type: none"> • Just and fairness of value • Equitable distribution of wealth to all stakeholders and disadvantaged members in the form of Zakat & Sadaqah • Social and individual welfare with both spiritual and moral obligation • Sensation of Equality
Principle 4: The role of stakeholders in corporate governance	
<ul style="list-style-type: none"> • In creating wealth, jobs and sustainability of financially sound enterprises 	<ul style="list-style-type: none"> • Islamic accountability to Falah and social welfare orientation • Haram/Halal dichotomy in transaction • Social & individual welfare from both spiritual and material • Consideration to whole

	community
Principle 5: Disclosure and transparency	
<ul style="list-style-type: none"> • Matters regarding corporation • Financial situation • Performance, ownership & governance 	<ul style="list-style-type: none"> • Accountability with Shariah compliance • Socio-economic objectives related to firms' control and accountability to all its stakeholders • Justice, equality, truthfulness and transparency • Wider accountability with written as well as oral disclosure
Principle 6: The responsibilities of the board	
<ul style="list-style-type: none"> • Strategic guidance • Monitoring of management • Accountability to company and stakeholders 	<ul style="list-style-type: none"> • Accountability not only to company or board or stakeholders but also to Allah the ultimate authority who leads to welfare and success • Holistic and integrative guidance • Negotiation and co-operation • Consultation and consensus seeking for each decision with related stakeholders

[Adapted from: Abu-Tapanjeh, A.M., 2009]

Chapter 7: Conclusions

Good corporate governance has long been considered central for stakeholders in the business environment, although the goals changing from one firm to another; however, the important concern is to push a good code of mechanisms to uplift and govern the firm. Meyer (2004) says that systematic governance means adjusting the signals within a firm such that staff automatically do the right things, without the need for oversight. Sound corporate governance practices have become critical to efforts to stabilize and strengthen capital markets and protect investors (Darman, 2005).

When stakeholders perceive good corporate governance, it builds their confidence in the organisation and the system governing the organisation in which they will be investing. This will lead to an increase in investment into the organisations and the opposite happens when they do not have confidence in the governance of the corporation where they wish to invest their money.

The governance of Islamic corporations has an added complication, that of compliance to the Shariah of Islam. An Islamic corporation is one that claims to follow the ethics and rules and regulations of Islam when it undertakes business, it does not mean one that is owned by Muslims or Muslim majorities. There are an increasing number of a people across the world that wish to invest within Islamic corporations, where the organisation follows the basic principles of Islam when undertaking business. The fundamental to this being the following of the Shariah when undertaking business.

The primary characteristic of the Islamic economy has been to provide just, honest, fair and a stable society as intended by the Islamic ethical values and rules that Islam promotes. I have to unequivocally agree with Ahmad, (2000), Mirakhor, (2000) and Warde, (2000), who said that Islamic business is forever considered by the Islamic ethical norms and social commitments which are resolutely based on the ethical and moral frameworks of the Shariah. Asyraf, (2006) held that the Shariah rulings intertwine Islamic financial transactions with genuine concern for ethically and socially responsible activities whilst at the same time forbidding

participation in unlawful activities or those activities that are damaging to social and environmental wellbeing.

The investors wish to have the same standard as international corporations that follow good corporate governance procedures, with the added component of compliance with the Shariah. They expect excellence in both areas, without those responsible for the organisation cutting corners in either of them.

Those entrusted to ensure that the organisations follow the Shariah and comply with the rules of the Shariah have taken on an immense task, due to the fact that Allah (SWT) will hold them accountable on the day of judgement for their actions. These people have placed themselves in positions of authority and responsibility for ensuring that the wealth of a Muslim is earned in a halal way. If they fail in this, Allah (SWT) will hold them accountable and the people who have invested into the organisation due to this will take them to task on the day of judgement.

The need to follow good corporate governance rules whilst complying to with the Shariah is an immense task, which many corporations have undertaken with distinction; whilst others have not fulfilled their duty and have fallen short for a number of reasons, greed and dishonesty being some of the reasons. The well-known cases of misappropriation of funds from Islamic organisations have resulted in a loss in confidence with these organisations and also with the wider Islamic finance industry as a whole. The fault of these people for their actions goes further than the misappropriation of funds in itself; the loss in confidence in the Islamic finance sector as a result of these actions will also fall on their heads also. If their actions have led to a general fall in confidence and mistrust of the Islamic finance sectors, then those, whose actions have done so, need to be held accountable. Some individuals will mistrust the Islamic finance sector to such a degree due to this behaviour, that they have taken their money and invested it within the non-halal form, as they believe that the Islamic finance sector is not trustworthy. These actions, although the responsibility lies on the owners of the capital, some of it has to be borne by the individuals who have contributed to this impression. Allah (SWT) will hold them accountable for this on the day of judgement, even though they may feel that they have escaped accountability in this life, and no matter how eloquently

they defend their actions and attempt to escape accountability and responsibility in this life, it will come to them on a day where they cannot escape the consequences of their actions.

This research has attempted to:

1. Analyse the problems facing Islamic financial institutions

These were undertaken by an extensive survey, the results of which have been analysed

2. Look at what the Islamic system of life mean for corporate governance of financial institutions

The Islamic way of life was explored, demonstrating and proving that Islam is a holistic way of life that affects every aspect of an individual's life, including his / her business transactions. These then had duties and responsibilities that the Muslim must adhere to.

3. How Islamic principles apply to corporate governance

Islamic principles of honesty, transparency, justice, competence, consistency, confidentiality and independence all apply to the business sphere of a Muslim.

4. What regulations and guidelines does the Shariah provide to regulate corporations

The Shariah provides guidance through the Quran and Hadith of the Prophet Muhammad (PBUH) to every aspect of a Muslims life. These have been codified into Islamic governance principles, including the comprehensive ones set out by the IFSB.

5. How the Islamic Corporate governance approach compares with the conventional approach to corporate governance

6. Is there a convergence in the approaches to corporate governance or is there divergence?

Corporate governance codes of good practice around the globe have a remarkable resemblance, all emphasise transparency, accountability, reporting, and the independence of the governing body from management.

The factors leading to convergence in conventional corporate governance include: -

- The codes issued by the World Bank and the OECD for example, clearly encourage convergence, as do the corporate governance policies and practices of corporations operating around the world
- Securities regulations for the world's listed companies are certainly converging, for example, The International Organisation of Securities Commissions (IOSCO)
- International accounting standards are also leading towards convergence. The International Accounting Standards Committee (IASC) and the International Auditing Practices Committee (IPAC) have close links with IOSCO and are additional forces working towards international standardization of financial reporting and auditing standards
- Globalisation of companies is a force for convergence. Firms that are truly global with world-wide production, service provision, added-value chain, markets and customers and whose investors are located around the globe, are moving towards common governance practices
- Raising capital on overseas stock exchanges encourages convergence, due to the need to conform to the listing rules of the market
- International institutional investors have unequivocally demanded specific corporate governance practices if they are to invest there

The forces for convergence in corporate governance are strong, with some

fundamental concepts having already emerged, including the need to separate governance from management, the importance of accountability to stakeholders, and the responsibility to recognize strategic risk.

Table 4 Comparisons between corporate governance in Islam and OECD Principles

Basis of Difference	OECD Principles	Islamic Principles
Authority	Directors have authority for decision- making. They follow the principles of OECD.	Sole authority belongs to Allah; all decisions are to be made by abiding with the Shariah.
Decision-making	Decision-making rests with the CEO and senior management. Voting is required just for the selection of a Board of directors (BOD) and few other decisions.	Consultation and consensus are required for every decision from concerned stakeholders.
Goal	Maximization of profits and shareholders' value.	Commitment to equity, fair distribution of wealth, and consideration for the whole community.
Accountability	Senior management accountable to shareholders.	Accountability to shareholders and to Allah.
Ethics	Transparency, accountability and disclosure.	Justice, equity, truthfulness, transparency, protection of minorities, wider accountability, written as well as oral disclosure.
Application	Principles are not equally applicable all over the world.	Equally applicable all over the world.

[Adapted from: Slahudin, C]

The OECD set of corporate governance principles have been efficiently implemented, whereas the more established Islamic principles of good practice, in place for fourteen centuries have not been efficiently implemented. The OECD Principles cover six different issues and rights related to corporate governance, whereas the Islamic principles essentially have a broader horizon and place duties

beyond shareholders, financiers, suppliers, customers, and employees, with a focus on the well being of humanity as a whole. The Islamic principles rest accountability ultimately on Allah, whose knowledge and authority are absolute.

Table 4 shows the differences between the OECD principles and the well-established Islamic principles. It is clear to see that there is no real conflict between the two, in fact the fundamentals are the same for Islamic and conventional approaches, as shown in Table 3 earlier. In fact Islamic corporate governance has essentially the same principles as conventional governance with additions of extra responsibility duty to the wider stakeholders they are responsible to, along with accountability to All (SWT) and the fact that the relationships between the stakeholders is different. For example, in the case of Investment Account Holders (IAH), instead of simply being depositors, they are viewed as investors (same as shareholders) and the responsibility that the organisation owes to them is similar as that to the other investors. These differences in the relationships between the stakeholders, and the fact that Islamic financial institutions have a greater number of them increase the duty upon the Islamic financial institution.

The Qur'an makes a clear and detailed requirement in respect of good practice:

“O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you... You should not become weary to write your contract down, whether large or small, for its fixed term, that is more just with God, more solid as evidence, and more convenient to prevent doubts among yourselves... Take witnesses whenever you enter into a commercial contract.”

[Surah Baqarah Ayah 282]

“And if you are traveling and cannot find a scribe, then let there be a mortgage taken... And do not conceal any evidence for whoever hides it, surely his heart is sinful, and God is Knower of what you do.”

[Surah Baqarah Ayah 283]

These two verses provide explicit guidance for disclosure and transparency. The emphasis is on making records of each aspect of the transaction so that there is full, clear disclosure for all parties; thereby preventing misunderstanding and conflict.

Accountability from the perspective of Islam is highlighted in the following verses of the Quran:

“O ye who believe! Fulfill [all] obligations.”

[Surah Al-Ma'idah, Ayah 1]

“O ye who believe! Betray not the trust of Allah and the apostle, nor misappropriate knowingly things entrusted to you.”

[Surah Al-Anfal Ayah 27]

In Islam, the accountability applies to the whole of life; the rules for corporate governance do not apply only to the Board of Directors (BOD), and senior management but also to every person associated to the organization. By contrast, OECD rules make senior management accountable to the Board of Directors (BOD) and the Board of Directors (BOD) to shareholders. Islam makes the responsible people accountable not only to stakeholders, but also to Allah (SWT).

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has issued the Governance Standards for the Shariah supervisory boards. According to these standards, every Islamic financial institution will have independent Shariah supervisory board's with specialist jurists in fiqh al-Muamalaat (Islamic commercial jurisprudence) with a wide ranging responsibilities and duties, just as the IFSB. It should be noted that the AAOIFI standard does not contain any information about the duration of a Shariah supervisory board's membership or on the possibilities and procedures of dismissal and reappointment. Notwithstanding the AAOIFI standards, the precise rules and criteria for the selection and appointment of SSB members, the applicability and credibility of their Islamic and secular qualifications, their scholarly reputation, their doctrinal stringency or intellectual flexibility, their main occupations and sources of income, the duration of

their Shariah supervisory board membership and reappointment, as well as the quantitative and qualitative dimension of their financial and non-financial rewards are not open to the general public.

Innovation generates new business opportunities, so long as the innovator has a competitive edge, when imitation sets in, temporary profits will diminish. Neither the management nor the Shariah supervisory board has any interest in too much revelation of the Islamic qualities of financial innovations as this could lead to imitation by competitors. The need to keep business secrets makes it even more opaque than conventional banking. Integrity of the Islamic qualities of the products and transactions is attained by the status and public recognition of the members of the Shariah supervisory board.

The technical details of new transactions and innovative products is complicated, and distinguished and well-known Shariah scholars with a deep understanding of financial techniques are very limited. This possibly explains why the names of the same Shariah scholars are found in the Shariah supervisory board's of several Islamic financial institutions, and in addition in advisory boards or committees of regulatory authorities and standard-setting organizations (such as AAOIFI or IFSB). Although the author believes that a world inhabited by over 1.5 billion Muslims, spread across 50+ Muslim dominated states and accounting for approx. 23% of the world cannot produce more than a simple handful of Shariah scholars.

This raises several governance issues at the policy level:

3. If prominent members of Shariah supervisory board determine the Islamic framework of Islamic banks, set the tone of public opinion and give advice to regulatory agencies, how will the independence of regulators be assured?
4. How will the independence of the Shariah supervisory board's be maintained when so many of the scholars are on the boards of the different companies
5. How will innovation be encouraged

6. How will the integrity of the product be maintained? If one Shariah supervisory board says the product is halal, so will the others, as they are the same people. Therefore, how will independence be maintained and the real of integrity of the board maintained
7. Competence of the Shariah supervisory board members, as they do not reveal too much information, according to AAOFI, then it is difficult to determine truly how competent an individual is.
8. And if the Shariah supervisory board is openly going to disregard the rules and regulations of organisations such as IFSB and AAOFI, then how can the honesty and integrity of the SSB be truly maintained?

The author believes the problems can be summed up as follows:

1. Islamic Financial Institutions need to understand the objectives, role and purpose of the Shariah
2. Islamic Financial Institutions need to appreciate the importance of good corporate governance
3. The need to follow the well-established principles of Islamic corporate governance, and not just pay lip service to them

The problems of corporate governance in Islamic financial institutions, the author believes are widespread, but this research demonstrates, have much to do with the application of the principles rather than the actual principles themselves. There are sound codified principles of corporate governance from organisations like IFSB and AAOFI to name two, which many have paid lip service to and have agreed to follow and implement. These principles are wide ranging and many are very similar to other renowned worldwide accepted principles, such as OECD with much commonality in them. The difference being the implementation of the principles; due to the reasons outlined earlier on how there seems to be a convergence in

corporate governance principles around the world, and the forces that seem to drive this convergence, the author believes this equally applies to Islamic financial institutions. The difference and divergence arises, because unlike OECD set of corporate governance principles have been efficiently implemented, the more established Islamic principles of good practice, in place for fourteen centuries are not been efficiently implemented.

Islamic banking is and will continue to be plagued with more governance issues than conventional banking; with the conflict between efficiency and distinctiveness of Islamic finance, it seems that the vitality of market limitations requires a proactive role in order to resolve the most serious governance problems and to preserve the uniqueness of Islamic banking.

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Appendices

Appendix 1 Corporate Governance Survey Questions

“Corporate Governance in Islamic Financial Institutions”

Name of Institution & Location:
Type of Business:
Respondents Name:
Position:
No of Employees:
No of Branches

Section 1

1. Type of firm

- ☐ Islamic Bank
- ☐ Investment Company
- ☐ Money Manager
- ☐ Insurance
- ☐ Pension Fund
- ☐ Stockbroker
- ☐ Consultancy firm
- ☐ Other.....

2. Indicate whether your board has the following committees (tick all that apply)

Governance Committee

Shariah Board

Executive Committee

Nominating Committee

Risk Management Company

Investment Committee

Compensation Committee

None of the above Committees

Audit Committee

Other.....

Other (Please Specify)

3. With which of the following statements do you strongly agree?

- ☐ Institutional investors are too involved in corporate governance activities
- ☐ Institutional investors are appropriately involved in corporate governance activities
- ☐ Institutional investors should be more involved in corporate governance activities
- ☐ Institutional investors should not be involved in corporate governance activities

Other.....

Other (Please Specify)

4. Are the Chairman of the board & CEO held by the same individual?

- ☐ Yes
- ☐ No
- ☐ Don't Know

5. Does the board conduct a periodic assessment of the board or director performance?

- ☐ Yes (Formal)
- ☐ Yes (Informal)
- ☐ No
- ☐ Don't Know

6. How many members are on the Shariah Board?

(If you don't have a Shariah Board - leave blank)

7. Do the Shariah board members hold positions on other Boards?

- ☐ Yes
- ☐ No
- ☐ We don't ask

☐ Don't Know

8. Are the Shariah Board members Employees of the organisation or consultants?

☐ Employees

☐ Consultants

☐ Don't Know

☐ Other.....

9. Does the board conduct a periodic assessment of the Shariah Board?

☐ Yes (Formal)

☐ Yes (Informal)

☐ No

☐ Don't Know

10. Does the board conduct an annual performance review of the Shariah Board?

☐ Yes (Formal)

☐ Yes (Informal)

☐ No

☐ Don't Know

11. Does the board set specific annual performance goals against which the Shariah Board is evaluated?

☐ Yes

☐ No

☐ Don't Know

12. Are any of the board members also on the Shariah board?

☐ Yes

☐ No

13. What is the remuneration package of the Shariah Board?

14. Does the board have a Shariah Board succession plan?

☐ Yes

☐ No

15. What is this Code of Ethics? (If they have one adopted)

16. Please indicate to whom the Code of Ethics is applicable (Tick all that apply).

☐ All Employees

☐ Directors

☐ Shariah Board members

☐ Executive officers

☐ Not applicable

☐ Don't Know

17. Has your organisation provided formal director education (onsite or offsite) to the Board of Directors in the past 12 months?

☐ Yes

☐ No

☐ Don't Know

18. Has your organisation provided formal director education (onsite or offsite) to the Shariah Board in the past 12 months?

☐ Yes

☐ No

☐ Don't Know

19. Are Shariah Board members formally educated about the workings of your organisation prior to joining or during their time on the board?

☐ Yes

☐ No

☐ Don't Know

20. Do you follow AOIFI standards, if 'Yes', in what capacity?

21. The majority of the organisations board consists of outside, independent directors who do not provide services to the organisation in any vendor capacity.

- ☐ Strongly agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Not Applicable

22. The organisations outside directors are independently minded in dealing with Company issues.

- ☐ Strongly agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Not Applicable

23. The Board and management work together to achieve strategic goals.

- ☐ Strongly agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Not Applicable

24. The Board has an updated role description that clearly outlines Board member responsibilities and qualifications.

- ☐ Strongly agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree

☐ Not Applicable

25. The majority of the organisations Shariah board consists of outside, independent Shariah experts who do not provide services to the organisation in any vendor capacity.

- ☐ Strongly agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Not Applicable

26. The organisations outside Shariah experts are independently minded in dealing with Company issues. Do you

- ☐ Strongly agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Not Applicable

27. The Shariah Board and management work together to achieve strategic goals. Do you

- ☐ Strongly agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Not Applicable

28. The Shariah Board approves the organisations strategic plan and reviews or updates it annually. Do you

- ☐ Strongly agree
- ☐ Agree

- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Not Applicable

29. The Board has an updated role description that clearly outlines Shariah Board member responsibilities and qualifications. Do you

- ☐ Strongly agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Not Applicable

30. The Shariah Board actively seeks, identifies and develops business for the organisation. Do you

- ☐ Strongly agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Not Applicable

31. The Shariah Board appropriately and respectfully challenges the status quo for the purpose of enhancing shareholder value. Do you

- ☐ Strongly agree
- ☐ Agree
- ☐ Neutral
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Not Applicable

32. Are there any standards for corporate governance set for financial institutions?

☐ Yes

☐ No

33. Are financial institutions required to provide any guidelines of their corporate governance structures?

☐ Yes

☐ No

☐ Not Applicable

34. Does any existing law have provision for Islamic banking and financial institutions?

☐ Yes

☐ No

☐ Not Applicable

35. Could you please name any associations that you are members of (if applicable)

36. What is the percentage share of the largest five shareholders?

37. What is the percentage of Shares held by the Board of directors?

38. Do the top management officials hold shares in the company?

☐ Yes

☐ No

39. Do the Shariah board members hold shares in the company?

☐ Yes

☐ No

40. Composition of board members

	Number
Total No of Board Directors	
Executive Board members	
Non-executive board members	
Members of the Shariah Board	
Other, please specify	

41. Are there procedures for the disclosure of any material interests in transactions or matters relating to the company?

- ☐ Yes
☐ No
☐ Don't Know

42. Do the Shariah Board or its representatives attend / participate in board meetings?

- ☐ Yes
☐ No
☐ Don't Know

43. Are corporate governance procedures and policies accessible freely to all the employees of the company?

- ☐ Yes
☐ No
☐ Don't Know

44. Are Shariah board decisions audited by independent Shariah experts?

- ☐ Yes
☐ No
☐ Don't Know

45. Are there procedures to monitor the conflict of interest of stakeholders, in particular Shariah Boards & Management Board in place at your organisation?

- ☐ Yes
- ☐ No
- ☐ Don't Know

46. Could you list the top 5 Shariah corporate governance issues facing an organisation such as yours at this moment in time

47. In your view what are the top 5 Shariah corporate governance issues at this moment in time.

48. Please feel free to make other suitable comments / suggestions.